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LECTURES
ON
Corporation Finance

By

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PREFACE

The following lectures are on the lines of the course prescribed in Corporation Finance for the M. Com. Examination of Indian Universities They are published for the benifit of M. Com. students. I have purposely abstained from laying before them masses of detailed narrative.

In the preparation of these Lectures no originality is claimed. The various sources from which information is taken are given below, and I gratefully acknowledge the assistance received. I would recommend them for detailed study.

Corporation Finance by Mead.

Finding Capital for Business by David Finnie.

Financial Policy of Corporations by Dewing.

Business Finance by Lough.

Organisation and Finance of Industries in India by Samant & Mulky.

Published Accounts by R. R. Gupta.

Business Organisation by R. R. Gupta.

I feel obliged to my colleagues Professors B. P. Gupta, M. A., M. Com. and A. P. Gaur, M. A., for giving valuable suggestions and typing the manuscripts; and I am grateful to Professor J. P. Rastogi, M. A., B. Com. of Meerut College, who has given assistance and his valuable time in going through the proofs while the book was in press.

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LECTURE I

What is Corporation Finance ?

Corporation Finance aims to explain and illustrate the methods employed in the promotion, capitalization, financial management, consolidation and reorganization of businesses on the lines of limited liability of Joint Stock companies.

When the Corporation or the Company is to be started the natural line of procedure is (1) investigation of a business preposition, the control of which is secured by a promoter who prepares a financial plan with the co-operation of other financiers or banks and then the sale of its securities, (2) problems which have to be faced during the working of the business e.g. those relating to the management of income in order that a regular rate of distribution of profits may be made by the directors to the shareholders, (3) in case the company needs more capital how it should be obtained .... either directly by the sale of securities or loans from the banks and other financing houses or indirectly by consolidation with other companies and lastly, (4) if the business happens to fail the procedure followed in bankruptcy and insolvency and the reorganisation of the insolvent corporation if possible, or its disintegration.

Financial need of modern industries and need for special organization

The processes of production, marketing and distribution which existed in the days previous to the intro-

duction of large scale production did not necessitate much enterprise on the part of those agents rendering these services. Production was carried on small scale. The merchants were catering for a limited market. Consequently the businesses did not involve much risk. These conditions have changed since industrial revolution with the introduction of machinery and consequent changes in the scale of production i. e. from small scale production we have come to large scale production. The markets have widened owing to the improved means of communications. The wider the market the more uncertain are its conditions. It is a very risky thing to produce for an uncertain and indefinite market. Thus the risks in production increase with the scale of production. As the risk in production increases the capital required to carry out such production also naturally increases. Such large amounts of capital cannot be supplied by a single individual or by a small group of individuals. The necessity of funds in large amounts which were beyond the capacity of a few individuals brought with it a certain form of organization which makes it easy to raise funds from a large number of individuals. As it was impossible for such large number of individuals to manage the concern financed by them the actual management had to be left with the chosen few. Of all forms of business organization which have to be introduced in order to facilitate the supply of funds from a large number of investors the most common and popular is the Public Joint Stock Company or corporation with limited liability. This form is followed extensively in the field of commerce and industry. The modern Capitalistic age is the age of Joint Stock enterprise and its outstanding

achievement in economic organization is the Joint Stock company whenever Capitalism appears. So the Joint Stock Company is the control and representative of the Capitalistic world.'

Essential Needs of Industrial Growth

The lack of industrial capital in the country which could be provided by Indians has retarded the industrial growth of the country. Industrial development implies two essential factors–the combination of initiative and managerial ability with the control and ownership of capital and the existence of a body of persons willing to invest. In this country there has been a lack of a wide class of investing public and specially there is the absence of a well developed money market. This is an essential preliminary to the development of industry and in India great difficulties have been experienced in finding sufficient capital for the public for requirement in businesses. Whatever industries have been established they have been developed with the help of Managing Agents because they had an easy access to their capital which was either in their hands or they had a command of capital in the hands of others. It is therefore quite clear that the modern industries need a large amount of capital and capital cannot be acquired unless there is a special organization to obtain that capital. Without a specialised agency the establishment of industries on a large scale is practically impossible.

LECTURE II

Promoters

Promotion is the first step in the establishment of a business. It may be defined as the discovery of business opportunities and the subsequent organization of funds, property and managerial ability of a business concern for the purpose of making profits therefrom. The original idea of the business if it is a new one arises in the minds of the promoters. The promoter performs an indispensible function in the community of discovering, formulating and assembling a business proposition by whose development the wealth of the society can be increased. He acts as the middleman between the investors and the man with undeveloped property to sell. In the present scheme of production, the resources and the money are lying uselessly apart. The promoters bring them together and wealth is the result. Left to themselves they may never meet. The promoter therefore renders a valuable service to the country by bringing these necessary elements together. It is the work of the promoter to search for new public demands or wants and to find means of satisfying them. Sometimes promoters may go beyond the promoter's business and undertake to conduct the business. The out and out promoter, however, does not entrust himself with managing a business after it has been promoted. A promoter may undertake to launch an enterprise because he feels that some other firm is making huge profits and he must share a part of them. He must be assured of good profits. If his purpose to promote a concern which can

make poor profits only and not monopoly profits, he must be sure that the standard of efficiency of existing concerns is so low that the new concern will be able to produce on effecient lines and at a lower cost and then he will be able to bring down the price of the product ; or in some cases the promoter may feel that the existing concerns are competing with each other on unhealthy lines which is injurious to the industry and that competition may be eliminated by means of the consolidation or combination of several competing units. The successful promoter makes a large profit, so large indeed that sometimes it is thought that he is overpaid for the services he has rendered. The fact is that he not only takes huge risks but renders valuable services to the society. He pays for the investigation of his projects. He has to consider its real value as a business proposition and commercial exploitation. He loses if such investigation results in the inadvisability of such an undertaking. He performs a public service whenever he produces a succesful concern or creates a new demand and that makes us live more comfortably or he supplies more utilities in a cheaper way or he saves the tremendous waste to the society brought about by unhealthy competition and unnecessary duplication of the means of production. In this way the promoter by rendering useful service to the society can and does make profit for himself.

Steps taken by the promoters in promotion of Joint Stock Companies.

The promotion of Joint Stock Companies presupposes the existence of a promoter. The promoter may be said to be the father of the company, who sees the prospects of gain in a business which he wishes

to set up and believes that he can persuade others to think as he does. Promotion is therefore the process of organising and planning the finances of a business concern in the form of a Joint Stock Company. The purpose underlying the promotion of a Company is to acquire some profit by the transaction. The promoter may sell his project to a Company and may have to do nothing with the Company afterwards, and in the transaction he may make a profit or he becomes concerned in the promotion and the working of a Company as a shareholder and director.

A Company may be promoted to exploit some new invention or underdeveloped natural resources or to take up a going concern. In the latter case a trader may find it to his advantage to convert his business into a company. He may like to retire and convert a portion of his interest into cash. He may convert it into a Private or Public Company. A business man who relies on his employees for managing assistance may convert his business into a company so that he may be able to have the continued co-operation and interest of the employees in the welfare of the business by appointing them as the directors. At the same time he can have the advantage of limited liability. Some times a business man converts his business into a Company so that after his death or the death of a partner the business may not be dissolved The person who is at the back of the conversion into a Joint Stock Company is called the promoter who may be either the proprietor of a concern or somebody else interested in the conversion. Or a syndicate may be formed specially for the purpose. They become the promoters. The old business is sold to them or to

their nominees, who sell the business to the company newly formed. The undertaking in the ordinary way is sold for a fully paid up value and the proprietor or the vendor receives the bulk of them. He may be paid something in cash at the same time. He may also acquire large power of control through the Articles of Association. In this manner the existing business is converted into a Joint Stock Company ; the object may be to make the business permanent or to acquire more money by inviting the public to subscribe to the share capital of the Company which may be needing more funds for the purpose of expansion.

In the second case the promoter accomplishes his purpose in three distinct steps (1) He makes the discovery of the idea (2) assembles the elements of the business (3) produces the funds in order to put these elements into operation. Discovery means determining that an opportunity exists for exploitation. Opportunity is a mere idea. It means the creation of new demands or further satisfaction of an old one that is not fully or completely satisfied or it may be the outcome of the thought that the person produces or manufactures or having exceptional or monopolistic profits which can be shared by another business which must be run on more efficient lines. The idea may come as a flash to an inventor or it may be an inspiration on the part of some of people engaged in a similar business to expand into somewhat new fields. The idea of discovery requires (investigation) which helps to find out whether it is feasible or not. The investigation must be undertaken by an expert who is able to weigh effeciently all the elements of business and may be able to find out the gains and risks involved in

the projected enterprise. The promoter should not try to arrive at any judgement or conclusion independently as he is optimistic and enthusiastic and consequently prejudiced in favour of his scheme. He cannot look at things in a disinterested manner. He cannot make an exact forecast as to whether the enterprise will be profitable or not. So the investigation should be entrusted to an expert.

Investigation is divided into the following steps :— 1. Rough estimates. 2. Detailed investigation. 3. Checking up of the results or verification. In rough estimates inquiry should be made as to who originated the proposition to see if it is properly sponsored. Then he should determine the basic idea in the business i. e. is it a manufacturing or a marketing idea. Will the product satisfy the old want or a new demand or a habit will have to be stimulated or created in the public. The aim of the rough estimate is whether it will pay to spend the time and the money in making a detailed investingation.

Detailed Investigation

Detailed investigation is a protection against a much greater loss in case the business is set up. The detailed investigation has to be entrusted to specialists. For example a manufacturing or production idea may be investigated by technical experts or engineers. If it is in relation to the consolidation of an undertaking it may be entrusted to Accountants or Business Experts. If it is with regard to marketing or the creation of a demand it may be left to the marketing experts. The scope of the detailed investigation will

be whether the projected enterprise will be a profitable concern or not. The experts will have to find out the capital cost, the estimates of the probable income or loss and the capitalising of an operating cost. It will mean whether the projected enterprise will make enough income or revenue to pay the cost of operation, the interest on the capital and leave sufficient profit to compensate the owners for their risks and services. The amount of fixed and working capital will depend on the business. Then the scope of business has to be determined i. e. whether it should be started on a large scale or on a small one and to expand gradually with the profits. What could be the right time to start production so that the market may be ready to recieve the goods. Whether the Company should engage in manufacturing and marketing at the same time. Whether the concern should buy their own plant or have it on lease. They may also consider the difficulties of raising capital and placing the goods on the market at a resaonable price. In short all the matters connected with the financing, production and management and the marketing of the goods have to be investigated in detail before a business is actually started and a Company is formed. In some cases it is advisable to check or verify the results of detailed investigation with the idea of making sure that nothing has been done in a partial manner and results have been obtainedon careful investigati on, right experience and mature judgment. The work of a promoter in connection with formation of a company either to take over an already existing business or to start a new undertaking may be summaised as follows:—

He concieves the idea of forming the company. He explores its future prospects in business. He

approaches others to convince them of what he believes to be a profitable venture, so that they may sign the Memorandum of Association and consent to act as its first directors. He fixes the name of the company and the amount and structure of its capital. He arranges for the underwriting and the marketing of the securities. He selects banks, auditors, brokers and legal advisers of the company. He sees to the preparation and printing of the Articles and the Memorandum of Association and Prospectus. He attends to the Registration of the Company by filling the Articles and Memorandum of Association and the Prospectus. He arranges for the completion of contracts with the Managing Agents, underwriters and vendors. He incurs necessary preliminary expenses. He issues and advertises the prospectus. He secures allotment of Shares after application for the same have been recieved. He arranges to secure the certificate for the commencement of business. He makes necessary arrangements for staff, machinery and office, as well as factory. It may be mentioned that in this country in the absence of any agency specialising in the promotion of companies, the person or firms who want to become Managing Agents usually act as promoters. Such persons act as pioneers, and finally become Managing Agents.

Promoter's Remuneration.

The promoters have to be remunerated for the services rendered by them in connection with the floatation of the company. Sometimes they charge higher price from the company for the business and other property they acquire and the difference is their profit. Or they may be allowed a commission on the

purchase price of the business or property taken over by the company or they may be granted a lump sum for the work done by them. The remuneration may be paid in cash or in fully paid shares or partly in cash and partly in shares. The remuneration paid to them has to be disclosed in the prospectus, for the information of the public. In this country, the promoters who become at last the Managing Agents, do not receive any remuneration as they expect to receive good earnings from the Managing Agency.

Financing an Enterprise.

The promotors must obtain the money to take up the proposition and inaugurate the business enterprise. He may directly obtain money from the investing public to whom appeal may be made by prospectus which may be advertised or circular letters may be issued. In other cases if the nature of the proposition perm'ts, the promotor may present it to the bankers and ask them to purchase or agree to purchase a sufficient amount of securities of the new company and to provide him or the new company with the money required. This is usually the case in the U. S. A. The promoter approaches a banker and tries to secure from him the funds required for the new company. The banker will examine the proposition and if the result of investigation is favourable he will purchase the securities with the expectation of selling them to the public. In England the promoter approaches an issuing house which exists for the purpose of obtaining new capital from the public. It is a connecting link between the public companies looking for the capital and the investors. It may be a merchant banker or financial agent for a group of trading or industrial concerns or finance companies doing investment business specialised or

unspecialised. The all important asset of an issuing house is its good name. The higher its prestige and financial standing the more it can pick and choose among the companies wanting capital and greater the care and facility with which it obtains money from the public. When the prospectuses are advertised the underwriters and the public look for the name of the issuing houses. It means that the status of the issue is determined by the status of the issuing house and the company seeking capital has to approach an issuing house of first class reputation to act as an intermediary. When the issuing house is approached the proposition is examined from a number of points: who are the directors of the company, what is the history of the company, and whether its past record of profits justifies the proposed issue. It has to be reasonably sure that the new capital will be profitably employed and that it will yield good result and return. Is it the type of issue that will appeal at the moment to the investing public ? If the result of examination is satisfactory the issuing house will provide the necessary capital in exchange for the securities which will be sold ultimately to the investors. In the United Kingdom special institutions to meet the financial needs of the industry have also been set up. There was established in 1930 a Bankers Industrial Development Company for the purpose of assisting in the rationalization of certain industries. Again in 1945, the Finance Corporation of Industry Ltd., and the Industrial and Commercial Finance Corporation Ltd. were founded. The former institution would provide temporary or long term finance for industrial businesses so as to assist their rehabilitation and development while the latter institution would supply medium and long term capital

for small and medium sized concerns.

Conditions of Industrial Finance in India

In India the Managing Agents have played the role of issuing houses of England. They are the chief providers of capital and the link between the investing public and the industrial enterprise. The banks are not prepared to provide funds to the company. The Managing Agents only are in a position to approach the bank for financial requirements. When the industrial venture is sound the facilities available may be adequate. In the matter of obtaining funds from the banks the experience of European and Indian Managing Agents is different. The European Managing Agents have felt that the banks in India have freely financed industries while the Indian section have experienced a great difficulty in getting the required finance. As a general rule the banks are not prepared to finance the long term needs of industry and are unable to provide more than the working capital for short periods only. The Managing Agents or their friends finance the enterprises in the initial stages. It is difficult to find either the share capital at the start or the working capital necessary to run the concern unless it is backed by Managing Agents' substantial resources.

The need for the establishment in India of special institutions to provide finance for long term requirements of industry and larger projects of industrial enterprise has been keenly felt, as the present stage of development of commercial banks does not warrant their taking substantial interest in the long-term finance of industry. In industrially advanced countries, various types of institutions have been set up for this

purpose. In Australia, the Common Wealth Bank has created an industrial finance department and the Bank of Canada has set up a subsidiary company known as the Industrial Development Bank of Canada. In the U. K. two special Corporations as referred to above have been established. The banks in Germany have played an important part in providing the initial capital.

In India something has been done on Provincial basis and it is gratifying to learn that the establishment of an Industrial Finance Corporation in India is under the consideration of the Central Legislature and a bill is introduced in the Central Assembly by the Finance Member. The object is to provide credit for medium and long term capital requirements of industry, which are outside the normal activities of commercial banks. The proposed corporation will have a share capital of five crores of rupees, the shares to be held jointly by the Central Government, the Reserve Bank, Scheduled Banks and Insurance Companies, Investment Trusts and other like financial institutions. There will be no private holding of shares. Shares of the corporation will be guaranteed by the Central Government as to repayment of principal and payment of dividend not exceeding two and a half per cent per annum. The corporation will be authorised to issue bonds and debentures for amounts which together with the contingent liabilities of the corporation, shall not exceed four times the amount of the paid-up share capital of the corporation. The Central Government will guarantee such bonds and debentures as to repayment of principal and payment of interest not exceeding two and a half percent per annum. The corporation may accept deposits from the public repayable after

a period of not less than ten years and on such other terms as the corporation may think fit. The corporation will be authorised to make long term loans to industrial undertakings, repayable within a period not exceeding 25 years and to underwrite the issue of shares and debentures subject to the provision that the corporation will be required to dispose of any shares or debentures acquired by it in fulfilment of its underwriting liability within a period of seven years. The corporation will not be liable to pay incometax or supertax on its income and profits, but the dividend paid to shareholders will be liable to these taxes. The surplus profits of the corporation after payment of a dividend not exceeding five per cent and after building up a reserve fund of five crores will be payable to the Central Government. The corporation will have special privileges in the matter of the enforcement of its claims against borrowers.

LECTURE III

Industrial Banks and Investment Trusts.

In India there is the absence of some agency or institution of an organised character to do what the issue Houses and the Investment Trusts do for industries in England and what the general banks do for the industries in Germany. Industry here lacks the assistance of an institution which would help in the formation of the industrial concern and in placing its shares and other securities on the market. Until now this service has been done in varying degrees of efficiency by the Managing Agents who were able to obtain the capital from parties associated with them by business or personal relations. Owing to certain adverse circumstances the Managing Agency System has been severely criticised and its prestige and popularity has diminished and consequently is not in a position to perform the function so efficiently. Further the practice of getting the shares underwritten is not very common. Promotors of new concerns usually consult their brokers as to probability of the success or otherwise of the new issue before offering it to the public. They are guided by their advice. On account of these drawbacks or the absence of facilities for obtaining the required capital for new industries, opinion in this country has long favoured the starting of indusrial banks on the line of the German Gross Bankers with a view to provide industry with initial capital. German banks are industrial banks whose main concern is the permanent provision of fixed capital to industry. These banks are only intermediary between the investing public and the industrial companies. They do not and cannot

furnish to the industrial concerns what the investing public is not prepared to offer. Then the banks give financial advice and general council through their representatives on the Board of Supervision. The German banks are not industrialists although they help the industries. Germany owes the great industrial development in a large measure to the enterprising spirit in banking. As soon as a company is founded it is immediately linked up with a bank. The bank will examine the proposition and if necessary will obtain reports from experts in the particular lines. If the report is favourable and it is decided to found a company it will draw up the scheme of financing, determine the amount and the type of capital to be issued and then in some cases itself take a part of the shares with the idea of issuing them at a later date. In this way the Founding Bank becomes at the same time an Issuing Bank. The bank will place those shares on the Stock Exchange through the intermediaries of the bank (brokers). In this way the bank provides credit to the company by means of advaces for periods varying from one to ten years. It finances long term contracts, hirė-purchases or instalment sales. The banks have given a prominent place in their programme to the promotion of Joint Stock Companies. At the same time they were alive to the dangers of extensive and permanent participations on their own account in the concerns which they brought into existence. They recognise the principle that it is their function not so much to bring various branches of industries into existence through large scale participation on their own account but to induce the capitalists of the country by the authority of recommendation to apply idle capital to undertakings

which were properly planned to meet the real needs of the country and were equipped with expert management and have prospects of reasonable profits and success. They would not themselves furnish to the industrial company what the investing public was not prepared to take. On the whole it has been possible for them to play a considerable part in the promotion of the industrial companies without locking up their own resources and they have been able to manage the promotion of companies on a large scale because the capital invested in these operations is constantly changed from one investment to the other and thus a considerable amount of diversification exists. This is possible because the banks are members of the stock exchange and deal directly with the securities. The banks are thus in a position to acquire new connections; they are not anxious to enlarge their dividends by industrial profits. They are very sympathetic towards industries. The intimate relationship between the industry and banks is the essential feature of German Banking System. The banks have their representatives on the Board of Supervision of the companies known as 'Aufsichtsrat'. This Board watches and supervises the affairs of the company. It examines the yearly Balance Sheet and any proposals to be brought before the general meeting of the shareholders. It reports on them. It has got nothing to do with the management or control which is in the hands of the directors. It is only in advisory position that the Board of Supervision exists. It is quite apart from the Board of Directors. It includes important leaders of industry and commerce. The Exchange of such representatives is a valuable link between banking and industry. In its turn industry has the support of

the Banks. The banks cooperate among themselves by joining togather in 'Konsortium'. They not only reduce the risk borne by one bank in industrial issues but are enabled to avoid undue competition among themselves and finally to undertake large operations not possible for any single bank.

Investment Trusts

In this country it is felt that there are no recognised methods by which the public can obtain advice and assistance as regards investments. Banks are unwilling to advice their clients about suitable investments, because they are held morally responsible if the investment turns out to be unprofitable. It is better for the inexperienced investors to purchase only old securities or to invest through the machinery of those who are experts in this matter and possess expert knowledge and financial strength to inspire the confidence of the investors in the ultimate success of the concern whose shares they seek to place on the market. Such experts are investment Trusts. Another argument in favour of the Investment Trust is that they help in the choice of investments and the investors are able to contribute to more balanced investment. Some people go still further. They say that in India Investment Trusts should be formed in order to supply the industries in their initial and infant stages, the necessary capital. It should not be overlooked, however, that the Investment Trusts confine their dealings to established securities and their primary aim has not been industrial, but financial. They are inadequate in a country which is more or less in the early stages of industrial development. However, there is a growing

view in the industrial world that direct investment by the public is too risky and that it should be taken out of the hands of the small capitalists, and the work of the investment should be entrusted to special financial institutions such as an Investment Trust. It is more so during the period of depression when the value of securities falls and the small investors are not in a position to judge the soundness of their investments. It is worth while to consider in detail the working of these trusts which in the opinion of the financial experts should be started in this country. These companies or Investment Trusts were established on the risks spreading principle. There is no such thing as absolute security in this uncertain world. There are two sound principles in investment which one ought to keep in mind :— (i) The object of investment is to secure income and if possible an increase in income and (ii) scarcely less important is security and liquidating of capital that is to say if the investor at any time wishes to realise his investment there should be probability that he will be able to obtain upon realisation at least the sum which he originally invested. There are varying classes of investment in shares and debentures of companies. Where the interest offered is generally higher but security of capital and income is less assured and there is unlimited variety in shares of industrial and other companies and particularly variety in shares commonly known as 'Equities'. Another method of investment gives the individual an indirect instead of direct ownership of shares of industrial enterprise, for example in a Holding Company this is the case. The growth of the Investment Trust is an important illustration of this

tendency. As there is a good deal of risk involved in investment it is necessary to possess knowledge and to make a careful selection and to ensure stability of income and certainty of the return of the capital. The funds which one possesses for investment should be spread over a number of investments of widely different character. This has given rise to risk-spreading principle. It was followed in the establishment of investment trust companies. The idea originated in England but was taken up after about half a century, by the U. S. A. In the early twenties the idea originated of creating a new channel for the investors based on the risk-spreading principle. In order to prevent unwise changes in the underlying securities by the directors the element of management was eliminated and this was the beginning of the trusts. The fixed trusts announced that it would invest funds entrusted to it by individual investors in the securities of certain specified companies and those only. The amount of the holding in each company was announced. The securities would not be sold and each individual investor would have a share in these investments for a fixed period of year. The dividends were paid and securities could also be sold after a fixed period. But by the time of selling the slump in America came. These investments were subject to enormous depreciation under slump condition and the purely fixed trust idea, as providing safety with risk-spreading miserably failed. It failed because the trust was irrevokably committed to specific investments which could not be sold even when it was apparent that it was no longer prudent to retain them. This idea of the American equities which eliminated all questions of management was modified

in England so as to stimulate confidence, and offer opportunities for risk spreading to small investors. About that time there was also keen depression in England. The trade was bad, the taxation high, monitary conditions uncertain and the investment market and investors suffered from a wide spread lack of confidence. At that time the people invested in safety first investments i.e., Gilt-edged securities and deposits in Savings Bank and Building Societies. The investors in equities had had a bitter experience to meet the position at that time the first fixed trust was formed in April 1931. The Management Company was given power to sell any of the underlying securities it thought fit on the occurrence of certain contingencies specified in the trust deed. The proceeds of the sales must not be in invested but should be distributed in cash to the members. In the English Trust therefore, the management was given certain power within definite limits to sell the securities. There was no flexibility in the earlier stage either with regard to securities or the management. It was an improvement to some extent upon the American idea. The idea of fixed trust was developed further until in some of the latest trusts the extent of flexibility with regard to securities and also to management were given to the managing companies. Thus there have been both fixed and flexible trusts.

Constitution and Management of Trusts.

There are three parties to the constitution. The managing company, the trustees, the sub-unit holders or share holders. The Managing Company may be a private company and in its hands is vested the central and management of the trusts within the limits of the

trust deed. The managing company enters into a trust deed with the trustees having no responsibilities whatsoever for the management. The duties of the trustees are of those of the custodians. The real control is of the managing company. The sub-unit holder is the investor. He purchases or sells sub-units of the underlying securities at prices fixed by the managing companies in accordance with the stock exchange quotations to which are added certain specific charges. The bases of investment by the Managing company is one unit. The prospective investor is informed of the composition of one unit, which is broken up into a given number of shares in each of the company whose shares have to be purchased. A unit is broken up into a number of sub-units. say 1,000 and investor in the fixed trust purchases through the Managing Company the number of sub-units he can afford e.g. he purchases 20 sub-units so he is interested to the extent of 20/1000 of all the shares comprising one unit. When a complete unit is purchased the securities are held by the trustees upon trusts. The trustees issue to the Managing Companies the number of sub-unit Certificates corresponding to the number of units represented by the investments which they hold on behalf of the Managing Company or more precisely on behalf of sub-unit holders. A trust generally places some limits upon the number of units which it will hold. It is known as full trust i. e., only the fixed number of units can be purchased by the trust. Any new investor in a full trust must buy a sub-unit from another sub-unit holder, the price at which a sub-unit may be sold is governed by the daily price of securities comprising a unit. Sub-units can be purchased or sold through stock-brokers.

They are not officially quoted on the Stock Exchange. There is generally a limit to the duration of trust between 10 to 20 years at the end of which the trust is to be unwound i. e., the securities comprising the sub-units are sold and the proceeds are distributed in cash to the sub-unit holders. Sometimes an investment trust company may be formed at the end of the period and the sub-unit holders instead of receiving the cash may receive shares in the investment companies in exchange for their previous sub-units.

The payment of Dividends.

Sub-unit certificate may be either to bearer or registered. If they are to bearer, dividend coupons have to be attached and presented through bankers to the trustees for payment. If they are registered, dividend warrants have to be issued. On the back of the dividend warrants are printed the underlying securities comprising a unit, the rate of dividend paid upon each holding and any cash received from bonus shares if they are converted into cash and the amount distributed. The total dividends and cash received from bonus shares are aggregated and divided by the number of sub-units in a unit. The amount payable to a sub-unit holder is thus arrived at. Such bonuses may be of a capital nature.

Selling Methods

Each group of fixed trusts issues a booklet giving a detailed account of the various fixed or flexible trusts in the group with the names of the Managing Companies and the names of the trustees. A list is given of the underlying securities comprised in a unit. In some cases a brief account of the past records of the company whose shares are the underlying securities

is given. The information is prepared in an attractive manner because it serves as the prospectus. Advertisements may also be given in the newspapers. They generally show the dividends paid and the main features of the trust. Points to be noted in the substance of the advertisements are:—

1. The opportunity for risk spreading is emphasized.
2. The invitation is mainly to the small investor.
3. The yield offered compares favourably with the yield offered by other investments considered to be very safe or giltedged securities.
4. The method of purchasing and selling sub-units is explained to be simple.
5. The managing company undertakes to effect sales of sub-units.

The Cost of Purchasing and Selling sub-units.

The cost to the investor of a sub-unit consists of the appropriate fraction of the aggregate purchase price of all the securities in the unit as quoted on the Stock-Exchange, plus costs which would be incurred in making such a purchase, plus loading charges, plus an amount to make up the price of a sub-unit to the nearest 3d. The loading charge is to cover the cost of managing the trust throughout its life. If, therefore, a sub-unit holder only holds his sub-units for a short time, he loses the benefit of the loading charge.

Choice of underlying securities.

When the fixed trust movement started, investments selected as the underlying securities were mostly market leaders-shares of companies which had a good dividend record and a reputation for sound

management and commercial policy. The selection was largely made from those companies whose finances suffered least damage through the period of depression and had maintained dividends though on a reduced scale. The shares selected on this principle were popular and it was desirable that the underlying securities should be readily realizable. The effect of the policy was two-fold. First, purchases by fixed and flexible trusts were concentrated on the shares of small number of companies. Such purchases strengthened the upward tendency of the market. If this process were to be continued it might happen that one trust or a group of trusts would hold a majority of the issued shares in certain companies. This would place in the hands of the Managing Companies, by whom the voting power would be exercised, wide influence and control over the companies whose shares were held. The Managing Company may thus change the directorate of certain Companies. The subunit holders have no control over the Managing Companies which are Private Companies. Purchases of shares made on behalf of trusts tend to create bulges in market prices.

We may also consider the reverse side of the picture when selling takes place. If there were disturbing news which created widespread loss of confidence, subunit holders might begin to realise in large numbers. The Managing Companies, having undertaken to dispose of subunits, would find it difficult to find buyers, and they would be compelled to sell a large number of underlying securities for cash at a time when market conditions are unfavourable. The existing state of affairs would be accentuated by their

own action and by the selling of other fixed trusts. Subunit holders are not particularly well informed on investment problems and their actions at such a time would not be dictated by the sound judgment. The real point is that the actual control of selling rests with the subunit holders and the Managing Companies are powerless to avoid sales of blocks of shares. The case of investment trust companies is different. The directors are not bound to sell shares held by reason of pressure from shareholders. The price of the shares of the investment companies would be adversly affected but the directors of the Investment Companies have wide experience and will exercise sound judgment. They are able to judge the market, and the appropriate time, and may be able to buy, at very favourable prices, large blocks of good shares which had been thrown on the market.

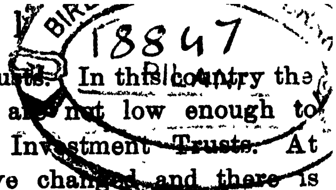
Problems of Control.

The success or failure of an investment trust depends mainly on managment and control. The real power of control except the decision to sell subunits is with the Managing Companies. These are private companies and the subunit holders have no control whatsoever in regard to them. The Managing Companies are partly brokers and partly jobbers in regard to the purchase and sale of subunits. Profits accrue from the loading charge, the jobbers' turn and the making up of the price of subunits to the nearest 3d. If subunits are sold early, the loading charge relevant to such subunits may become mainly profit. The subunit holders are given a share in the profits. The subunit holders have no power of corporate expression by attendence at general meetings. They do not receive

any account of the Managing Company and have no knowledge of the profit made by such Companies. It may, therefore, be concluded that in capable and honest hands the trust will achieve success. The success of investment trusts and public confidence in them mainly depend upon the integrity and the wisdom of the Management. Another important point in successful management of an investment trust is that the Managing Companies should not purchase for trust any securities which they would not be willing to buy for themselves. They should not buy such securities as can not be held for long.

Investment Trusts In India.

We have seen above that the investment trusts in England and America have been formed on the risk-spreading principle and they have proved advantageous to the small investors who do not possess expert knowledge of the various industrial concerns and the securities issued by them. In this country, the investors, and specially those who have not large funds for the purpose of investments do not possess sufficiently expert knowledge for investing their money. In the absence of any special institutions which will assist them in selecting the safe and profitable security, it is highly disirable that investment Trusts should be established in this country. There is, however, a class of people which doubt the advantages to be derived from such institutions. It is usually believed that Investment Trusts have to rely on the possiblity of cheap finance in the Capital market. It has to borrow at a cheaper rate from the public in the form of its own debentures and preference shares than the yield of the investment securities



acquired and held by the trusts. In this country the rates of interests usually are not low enough to warrant the formation of Investment Trusts. At present the conditions have changed and there is plenty of money in the hands of investors seeking good channels of investment. The investors do not possess sufficient information and in some cases, are incapable of collecting reliable information or obtaining expert advice regarding the financial stability of industrial concerns whose growth may be considered as mushroom. The Investment Trusts, if managed properly by persons possessing necessary experience and managerial honesty and integrity, would go a long way in helping the investors who are on the look-out for safe investments. It has to be admitted, however, that the trust in order to succeed must win the confidence of the public. It may be necessary to give sufficient protection to the investors by adding some provisions in the Company Law, or it may be necessary, to enact special legislation.

Another difficulty which has to be met in starting investment trust in India is that there should be a large number of investments so that the risk involved may be distributed over them. It is true that the diversification of industries in this country has not been achieved in any marked degree, but the industries are developing at a high speed and the policy of the Government and the anxiety of the industrialists is well directed so as to achieve the objective of industrialising the country within a short time. The last war has helped considerably the growth and development of many new industries and there is no reason why with the industrial policy of the State

they should not develop further. Even at persent there is enough scope for the diversification of investments to reduce the risks of investments. It may also be added that there are not only large number of industries so far developed but also the industries are distributed over different financial centres. The Investment Trust can diversify its investment further by distributing the finance among industries at different financial centres in the country.

LECTURE IV

Underwriting of Industrial Securities.

The promoters of a company are always sure and optimistic regarding the issue of the capital and they take particular care to see that the issue is carefully prepared but it does not necessarily follow that the public will subscribe to the whole of the shares offered. The Issuing House and the promoters may have misjudged the temper of the investing public and the offer may not appeal to them. Some other reasons may prevent the public to be attracked towards an issue. There is always a short interval between the decision to make the issue and the actual offer to the public. During this interval some events may occur to unsettle prospective investors and they might be prevented to submit their application forms. e. g. there may be a sudden tightness in the money market or there may be some political disturbance. It is therefore, a matter of primary importance to all concerned with an issue to insure against the risk of the public failing to subscribe the capital offered. This insurance is effected by having the issue under-written. The under-writers guarantee the issue i. e., they guarantee that if the public does not subscribe the full issue, they will make up the difference and the company will receive the full amount of the capital offered.

Meaning of underwriting.

The term under-writing originated in the custom of English merchants gathered in Lloyds famous Coffee House of writing their names at the end of certain documents in order to divide and assume the risk of marine and other hazardous enterprises. This

practice was commonly called Syndicate Underwriting of Corporate Securities. The underwriting Syndicate became well known to the financiers of England and America about the year 1875. The practice probably originated in France. An Under-writing Syndicate was defined as an Association of persons who guarantee the subscription to the issue either wholly or partially and each guarantor usually accepting the responsibility for so much to the actual contractors. The under-writing practices usually differ in England and America. The English Corporation usually deals directly with the public and with the under-writers, while in America the Corporation deals with a Syndicate Manager. However. an under-writing agreement means an agreement entered into before the shares are brought before the public. That in the event of the public not taking up the whole of them or the number mentioned in the agreement; the underwriters will for an agreed commission take an allotment of such part of the shares as the public has not applied for.

Purpose of Underwriting.

1. In the first place the sale of securities for cash is assured and secondly sometimes the promoters of the corporation are in a position to take advantage of the finances of the under-writers before the securities are actually sold. Though the securities may sell as rapidly as could be expected it may require some time for the sale of entire offering and the funds may be needed at once. Sometimes again it may be desirable to keep the securities off the market while the funds are needed at once and thirdly the under-writing insures the (refunding of securities) e.g. if certain debentures or bonds are about to become due

a new issue may be offered to the old holders. Cash may be insisted upon by some of the holders. In anticipation of such a contingency, the corporation will make a contract with the Syndicate by which the latter agrees to take up the bonds of these holders who insist upon cash. The Syndicate will then exchange these bonds for the new issue. Fourthly. under-writing assists in the conversion of securities. e. g., 7% Preference shares may be converted into 5% debentures or some such other arrangement. The holders of the shares cannot be forced to make the conversion. The Syndicate would buy the stock at a low price and will offer it in exchange of the debentures; and lastly under-writing is very helpful in the promotion of consolidations of corporations and the reorganisation of corporations. The under-writing Syndicate agrees to pay to the dissatisfied holders of the old company and to take over their holdings in the new company.

Advantages Of Under-Writing

1 The Company that issues under-written securities is absolutely assured no matter what the conditions of the money market, and, no matter what reception is accorded to its securities, that its money will be available at the agreed date. 2 At the same time the danger of discredit or of financial embarrassment from a failure to sell the securities at public offering is eliminated. 3 Any unsold securities are quickly taken up by the under-writers and the Company issuing the securities pursues its course undisturbed.

Under-Writing Vs. Direct Sales.

The question of direct selling frequently presents

itself to a corporation. There is a feeling among the public that the corporation which resorts to offering the securities itself and cannot find under-writers to offer its securities is not a sound proposition. This reason is quite sufficient to deter most corporations from attempting to advertise and sell their own stocks and shares. Secondly, it would cost the corporation a great deal to sell its stock or bonds to the public directly through a campaign of advertising. It may have no facilities to sell; on the other hand the under-writing Syndicate have all these facilities. Again, the under-writers will always investigate the proposition fully by experts before they agree to take up the issue and consequently the investor is protected if the proposition is backed by under-writers. The under-writers practically gurantee the soundness and desirability of the security they offer. This being true the under-writers become an ally of the Company and the watch dog of the outstanding securities. They cannot fail without discredit and loss to them. All this reacts strongly to the advantage of the corporation. If, however, the corporation enjoys strong credit and the securities are conspicuously attractive and the general investment conditions are very favourable, any direct sale by a corporation will succeed and there is no reason why corporation should not try to market their own securities.

Under-Writing Procedure.

There are two distinct plans pursued in ordinary under-writing. Under the first plan the securities are offered to the public by the Company which

issues them. The under-writers then merely stand behind the offering, undertaking to purchase the securities themselves, if they are not purchased within a certain time by the public. Under the second plan the under-writers practically purchase the securities paying for them at such times and in such amounts as may be agreed. The under-writers then either sell the securities at once or hold them until such time as they can be disposed of to advantage. In either case, the Company have its money as not further directly concerned. The method of compensating the underwriters varies with the plan adopted. Under the the first plan an under-writing price is fixed for the securities i. e., the under-writers must purchase at the fixed price if the public do not. In this case the under-writers fix a less price than what is fixed for the public. If all the stock which is offered is sold to the public the under-writers are released from their obligation and receive their agreed compensation which is usually the difference between their price and the price to the public. This may be then equivalent to the insurance value of their guarantee. It may not be excessive by way of compensation. If the public does not take up or a portion of it is left the underwriters must then purchase all unsold stock at the under-writers price. The Company's transaction ends, it has sold its stock at a low price and has received the money needed for the purposes of the Company. All the securities are disposed of. The under-writers have to rely on a future sale and probably at an advanced price for their profit. Their profits may be considered as postponed.

Under the second plan the stocks are sold to the under-writers at such a price as will allow them a substantial profit as on a resale. This is usually done by these corporations who do not think that their securities will be purchased by the public. They, therefore, make a bargain with the under-writers to take over the entire issue at an agreed price. The price is usually less than the price at which they will be sold to the public. The difference between the two may represent either the commission for selling the securities or the profits of the under-writers or their compensation. The profits usually depend upon the kind of security dealt in. On some securities which may be considered popular, it may be low. In other securities which may be of a risky character, the profits may be quite good, although the under-writers assume a good deal of risk and responsibility with regard to the capital required.

Requirement Of Successful Underwriting.

There are two important factors which must be considered for success in underwriting. Firstly the underwriters must be men of financial responsibility and standing. It is expected that the securities will be sold when offered. But the whole object of the underwritng is to assure their shares and if the public will not take the securities the underwriters must carry out their guarantee and purchase the securities. If the underwriters are of good financial standing the fact shows that the underwritten enterprise is of the highest character and as such in itself adds materially in affecting the public sale of the securities. The name of the underwriters is a very impressive endorsement of the enterprise and

leads to the success.

The second important factor is the offering, i. e. the Company must be substantial and it should be large enough to entrust the underwriters of wealth and standing. The offering, therefore, must be attractive and then there should be right conditions existing in the market at the time of offering the securities. In a period of boom any offer could secure under-writing because the financiers of high standing take it for granted that any issue could be worked off on the public without the guard and care to its real value. On the other hand the guard in a period of depression or uncertainty is necessary as the public is very critical and is not in a mood to buy securities of any kind even though good. If the securities do not command the confidence of public, they cannot be sold. Accordingly the underwriters are forced to purchase in quantity and at prices that might be disastrous to them. Under such conditions there are very few underwriters who are prepared to take up the financial responsibility.

Underwriting Syndicates.

Underwriting is usually resorted to in the organisation of new and substantial corporations or when combinations are made or when additional capital is to be raised for any concern of a sufficient strength to make up underwriting possible. In underwriting or in purchasing the securities outright it is usually the banker who undertakes the responsibility of transaction. The bankers usually associated with himself a number of other individuals and banking houses in an organisation known as an underwriting or subscription syndicate. The difference between under-

writing and subscription is that in underwriting the securities underwritten by the banker are offered for sale by the corporation through the banker and in subscription the securities are purchased by the banker and offered by him to his own customers as sound investment. The underwriting corporation is a voluntary and temporary association of individuals or firm or corporation which is formed by a syndicate manager usually a banking firm to assist them in guaranteeing the sales of securities on purchasing an issue of stocks. The duration of syndicate is for a short period. The maximum duration of the syndicate is usually stated in agreement, but the manager is given power to terminate the agreement at an earliest date. Much depends upon the nature and amount of securities besides our selling organisation and the condition of the general security market. Syndicate may be formed for various purposes. Underwriting syndicates are formed for assuring sale of securities of a corporation. The attempt to sell the underwritten securities to the investing public may be made either by the corporation or the syndicate manager. In underwriting syndicate there are three interest concerned, the corporation, the syndicate manager or a banking house who gets up the syndicate by arranging the conditions of purchase from the corporation and thirdly, the subscribers. They share among themselves whatever risk is involved in the final distribution of securites. The underwriting syndicate is an usual intermediary between the issuing of securities by the corporation and their final absorption by investors and investment institutions. Subscription syndicates are those which subscribe to securities either with the

object in view of holding or reoffering them to the public. The effect is the same as that produced by the underwriting syndicate. Whatever form the syndicate might take, the following steps are taken in the organisation of syndicates.

The original contract is made between the banker and the corporation by which the banker agrees to either purchase securities at a price or to guarantee their sale within a certain time at a certain price. The corporation looks only to the syndicate manager for the fulfilment of the agreement and is not concerned whether the banker associates others with himself in the transaction. The part played by the syndicate manager is very important one. He associates others with himself as it helps him in selling the securities and at the same time he is able to spread the risk by admitting other bankers with wide connections and large number of clients to share in the profits of its subscription. A banking house obtains a broad market for the securities which it has for sale and while adopting this policy in all its undertakings it makes sure of quicker 'Returns'. After the contract is made the banking house communicates with a number of houses and individuals with whom they have cooperated and whom they wish to join. The banking house will ask each one to indicate immediately the amount of participation in the syndicate which is to be set up. Very few will decline to participate because those who may refuse may not get the chances of cooperation by others. After the replies have been received, amounts are summoned up. The application for participation in the syndicate may exceed the amount of securities

which have been underwritten or purchased or they may be below the required amount. In the second case he has to assume the responsibility for the balance. He may have to undertake it for a much larger part than he originally intended. Usually this is not the case because this contingency is guarded against by offering participations in the syndicate to such a large number of financiers as to make it unlikely that the combined subscription will be below the amount which the syndicate manager considers necessary. Now the syndicate manager has to allot these subscriptions. If the subscription is twice than necessary, each subscriber will receive half of the amount subscribed for. This becomes a voluntary association or a temporary corporation which is in process of organisation by the syndicate manager. It is a business enterprise which he is promoting for the individual benefit. The allotment of subscription is made according to his understanding of his own advantages. He considers only his own interest and the interest of the corporation for whose financial affairs he is temporarily responsible. The principles which govern this allotment are as follows:-

1. In the first place he wishes the floatation to be a success and he makes his allotment with this object principally in view. A particular kind of securities may in his judgement find a ready market in a certain locality. He will allot the full amount of their applications to that district. The bankers of other districts where the floatation of a similar character has failed previously may have to be content with a small share of their applications. Another consideration is that the individual financiers will have to be

considered because the syndicate manager has to look to his future. He has to participate in under-writing syndicate managed by other bankers. He must consider favourably the application from a banker who is himself a manager of another syndicate. He must give that banker what he asks for since otherwise he might himself be cut off from some profitable participation in the future. In short, participations in syndicates are alloted for the sake of securing participations in other syndicates. A banker must create a goodwill with the other banks and trust companies. He may have to borrow money. In short, he has got the chance now by the disposition of the allotments which are entirely in his hand to strengthen his financial position as well as influence and to cultivate business goodwill. After the syndicate manager has decided upon the allotments he sends to each subscriber a copy of the Syndicate Agreement which the subscriber signs and places the amount of his allotment opposite to his name. The subscriber is then bound by the conditions of the Agreement upto the amount for which he has subscribed.

Under-Writing Agreement.

A complete under-writing usually evolves two agree-ments.

1. The under-writing Agreement between the Corporation and the manager of the syndicate and

2. Syndicate Agreement between the manager and the participants.

The first one is an under-writing agreement. The terms of the under-writing agreement depend on the nature of the transaction to be entered into. The

contract may be in the nature of true under-writing i. e., the syndicate may be bound to take such securities as are left after a public offer has been made either by the manager or by the corporation itself. In such an agreement the important part of the contract will be the net price of the securities, i, e., the amount which the corporation is to receive and also the gross price i. e., the price to be paid by the investing public. The time at which the entire net price will be paid or if it is to be paid by instalments, the times at which payable. The purpose of such an agreement is to provide the corporation with cash as the work of corporation goes forward. The underwriting agreement may also be between the banker and the corporation, a contract of sale of Securities from the corporation to the banker and the payments to be made at certain time or times. In this case the agreement is a purchase agreement which has to be followed by a Syndicate Agreement between the banker and the participants who are united to underwrite for the banker instead of, for the corporation.

Sale of Securities to the General Public.

Purchase agreement may be made in the form of an exchange of letters. In outline form the terms of a typical under-writing agreement may be set forth as follows :—

1. Purpose of Agreement (particulars).

2. Recitals of conditions of the Company. Amount of securities to be issued.

3. Exact description of securities.

4. The price.

5. Rate at which securities are to be sold.

6. Special obligations of the corporation e. g., to permit examination of books and plants, to pay selling expenses and to supply any other information which the under-writers may require and

7. A provision may be made that securities may be rejected if they are found to be illegal.

Syndicate Agreement.

The Syndicate Agreement brings the participants together and gives them respective rights and obligations. Provisions, which are usually found are :—

(a) It begins with all particulars containing facts in summary form which are included in the Under-writing Agreement.

(b) The second clause states that the participants agree to take and pay for the amount of securities when called upon by the syndicate manager.

(c) The subscribers agree that the syndicate manager shall have entire charge of the marketing of the bonds or stocks. That he may make any contracts and incur any expenses necessary to secure their sales and that all these charges and expenses shall be the first claim upon the profits of the syndicate. Usually a large discretion is given to the syndicate manager.

(d) It is agreed that a syndicate manager shall assign to the members of the syndicate a certain percentage of the profit on the transaction reserving a portion usually one-fifth as his own profit.

(e) The syndicate manager reserves the right to participate as a regular member of the syndicate.

(f) Any member of the syndicate may at any time withdraw any of the securities at the price named in his subscription.

(g) That any member may assign his responsibility to the Syndicate manager or with his consent may be relieved of his responsibilities.

(h) It may be provided that the members of the syndicate are to cooperate with the syndicate manager in borrowing a portion of the price of the securities under-written or subscribed for from the banks and

(i) The syndicate manager agrees to be responsible ~~for good faith~~ in the management of the syndicate and in the distribution of the profits.

Advantages of the syndicate under-writing to the Corporation.

There are a number of reasons why the corporation will find it advantageous to have its securities under-written :—

(1) The corporation will get the benefit of the syndicate manager's advice on the kind of securities to be issued. The amount to be issued and the time and conditions under which they are under-written.

(2) It is sure to get the full amount of money when and as required. The corporation can make and plan its construction programme in full and in detail. The corporation has not got to depend upon the willingness of the investing public for funds and consequently there can be no delay in carrying out the plans.

(3) The corporation's credit is maintained, since the syndicate for its own benefit maintains the price

of Company's securities. The mere fact that the sale is under-written tends to establish the investing-public's faith in the securities and in the company issuing them.

(4) The syndicate manager is likely to keep watch over the company and thus aid and guide it in order to maintain his own reputation which is involved in the success of the Company after he has made representations concerning the Company. If a Company has established close relations with a banker it may even expect to get temporary accommodation during bad times, and

(5) Syndicate sale insures wide geographical distribution of securities and, therefore, saves them from future adverse local money market influences.

Advantages to Syndicate.

The chief advantage of syndicate under-writing to the participants is the profits. At the same time they are enabled to obtain for sale to the customers various kinds of securities. This gives an opportunity to their customers to spread the risk over various kinds of securities.

Advantages to the Public.

The close cooperation of banking houses enables them to arrange public offer of securities at different times. The market is not at one time glutted with securities but issues are always available to absorb the steady accumulation of investment funds by private investments and investment institutions. In other words the syndicate has a steadying effect on the market.

Advantages to the Buyers.

The investors who buy under-written securities are assured that their securities and the corporation issuing them have been carefully investigated. They are assured that their money is going to be associated with other money sufficient for the successful project. The investor gets the advantage of the continued supervision of the Company's financial affairs by the syndicate manager.

It may, therefore, be summarised that the fundamental and essential characteristics of all underwriting syndicates is the assumption of risks incidental to the sale of securities. They are also rendering social and economic service as well. The participants are banking houses who are financial experts and are in a position to measure accurately the worth of the new enterprises. There is less likelihood of industrial failures and waste of public funds than if it were attempted to distribute the securities directly to the public. Further, the necessary funds are supplied to the corporation and the securities may be carried until such time as it is expedient to sell them. The manager must pay for the securities before making any marketing. The Manager instead of tying up his own money may apply for loans to a Trust Company which expects a commission or a high rate cf interest for rendering necessary help. In this way the Syndicates render economic service to all parties concerned.

Under-writing in India.

In the Western countries most of the public issues are underwitten but in India the under-witing is not

so developed. This business is mainly in the hands of managing agents, share-brokers, commercial banks and investment trusts at present. Till recently there were no such special agencies as Issue Houses, Investment Trusts, Finance Companies, which would undertake the underwriting of industrial securities. The Joint Stock enterprise had not sufficiently developed and the investors, who cared to invest in industrial securities were few. The industrial securities did not command the confidence of the public. The securities of the companies which needed under-writing did not appeal to those who could underwrite them as there was a good deal of risk attached to such securities. Further, the existence of managing agents hindered its development. The securities offered by companies under the management of financially sound firms of Managing Agents did not need underwiting as they could be sold easily. The managing agents do not like to submit their proposition to the scrutiny and examination of the people who would come forward to underwrite them. These obstacles are, however, disappearing slowly in the way of the development of underwriting and the number of Companies whose shares and debentures are underwritten is increasing.

LECTURE V

Marketing Of Industrial Securities.

An offer of securities may be made by a going concern in need of additional capital or by a newly organised company. The ease with which a going concern can dispose of its securities depends upon the nature of the past results of the company and the characteristics of its offering. Newly organised enterprises may find it comparatively difficult to secure capital. The degree of difficulty depends upon their ability to impress prospective purchasers with the probability of success while on the other hand a going concern has the advantage of past performance as evidence of the quality of its issue and can also appeal to wider range of buyers who might be knowing the company fully. Then there is another important question whether the financing is to be made direct or through an agent. In this case much will depend upon the financial relationship of the managers.

Securities may be offered to Share-holders, Debenture-holders, to Creditors, Customers, Employees, Personal friends of the management or to the general public.

To The Shareholders And Debenture holders.

A going concern desiring to market a new issue of shares or stocks must give its old shareholders the first opportunity to take up the new offering. In this case the shareholder's right with regard to subscribing the new issues have to be observed, e. g., each shareholder may subscribe to the new issue in proportion to his holding with certain inherent rights which may

be in accordance with the following principles.

Firstly permitting existing stock holders to keep proportionate control, meaning thereby, that after having obtained the new issue they are in the same position as before so that any one of them may not be able to have the clear majority and secondly, the equities in the surplus must be preserved, that is, the old stock holders may not be put to any disadvantage. In fact the old shareholders possess the privilege of subscribing to the new issue of stock. It is known as their right. If the Comany does not offer its new shares to them and sells to the outside public, the shareholders may recover damages for any loss to which they are put. It may be a little hard on the company but from the financing point of view it has to be admitted that the old satisfied stock holders form a group of ready buyers of the company's securities. The cost of disposing of the issue will be the least. Furthermore, the purchasers are, for the most part, investors and they will not try to manipulate by their speculative activities the shares of the company. On account of these reasons it is advisable to offer new securities to its old security holders.

To Creditors

Another group of buyers that may be approached by a going concern is its creditors, although this practice is usually limited to cases of re-adjustment and liquidation where the stock of new organisation is offered to the creditors of the old company in the full settlement of debt. In some other cases the creditors of a prosperous concern may be attracted to make investments as a token of appreciation and continued partronage. They may also like to share

in the prosperity of the concern by which they may be able to obtain better return on their capital which has been lent to the Company.

To Customers.

This is possible in the case of a going concern with its established connections. The customer is familiar with the business and its earning powers. He is, therefore, a good prospective buyer. Moreover, the corporation which can sell the securities to the customers is assured of their patronage. This plan is very useful in the case of public utility concerns bacause there can be very little misunderstanding between the company and the public who are interested as shareholders.

To Employees.

Employees ownership is partly philanthropic and partly politic in motive. It is not to be relied upon as a sourcc of copital fund. Organisations which have made a practice of offering securities to employees have done so primarily to maintain the goodwill of the workers or for establishing friendly relations between the company and management. This is usually done by profit sharing schemes. Only in very small companies the salaried employees may be able to subscribe to the new capital. There is, however, a danger in admitting employees. In case the dividends have to be suspended the goodwill may turn into hatred and bad relationship between the parties concerned.

To Friends.

A successful going concern may be able to raise capital from personal friends of promoters or

managers and in a newly organised company this is very important if not the only source for obtaining new funds. It becomes a matter of obligation which may have serious draw backs. At any rate they are an important source of funds.

To General Public.

The general public in most cases absorbs the greater share of financial offering. These offerings may be classified as pure investments, legal investments, businessman's investments and speculative securities.

(a) Pure Investment Securities.

Pure investment provides the investor with a security of ready marketability, of definite minimum rate of income, and of great safety as to principals. The investor assumes no risk and expects in return control in the corporation and a high rate of income. Among such securities are those whose earning power is several times the amount required for investment. Preference stocks of well established corporation will give excellent record of best examples. Common stocks or ordinary shares cannot be considered as such because their value moves too freely with the fluctuating earnings of the corporations.

(b) Legal Investments.

Such Investments are those which are governed by law, e. g., the giltedged securities in this country known as Trustee securities.

(c) Businessman's Investments.

The securities which promise a fair rate of income with little risk are sometimes called businessman's investments. The businessman is prepared to bear some risk but chosing so he expects a fairly high

rate of income. The corporation must be a substantial one and the outlook for future must be hopeful. They include ordinary shares of industrial companies of high standing.

(d Speculative Securities.

In these there is a greater element of risk depending entirely on the amount of available knowledge concerning future earnings. The securities may pass from the stage of speculative to that of pure investment if the element of risk no longer exists; but so long as it carries the risk and the company's performance has to be tested and its prosperity is not proved it is speculative.

Different Methods of Selling Securities.

There are two methods of selling securities either to the public direct or through investment bankers. In fact the security business is organised on the same lines as the business of producing and selling commodities. The corporation corresponds to the manufacturer and the investor to consumer. Between them stands the distributor or the wholesaler. The bank occupies the same position in the field of securities as the wholesaler in the field of commodities. The bank or a trust company buys from the corporation and sells to his own clients or in the general investment market. There may also be special financing institutions for this purpose. These institutions offer investment securities suitable to the needs of various classes of investors, furnish free of charge, accurate information in securities, open the account of the investors, collect and remit dividends and interests, negotiate loans on those securities, purchase and sell or exchange securities. This may be done either by a private banker or a jobbing house

who has a large number of present, prospective or potential customers. He sends circulars at intervals to them or he brings the securities to their notice by public advertisements. In fact he is able to sell sometimes these securities before he has to make his final payment. If he is not able to sell he uses his own credit with other banks and trust companies pledging the securities as colletral for loans. Thus with the small capital he is able to do a large business. These investment bankers are always ready to purchase securities of corporations for cash. They offer a little lower price than they expect to receive. The margin of profit depends upon the saleability of securities.

There are advantages to a corporation in placing a security with investment bankers. First of all the cost of selling securities to the bankers is much less than that when its sales are made direct to the public. Secondly, the corporation is sure that the money will be paid to it at a definite date. Thirdly, the banker has a permanent organization and an established clientele of customers, who will buy from no one else. Fourthly, they are able to make a market for new securities for which there may not be much demand in the beginning. For doing so they will exchange the new securities for the old, and lastly they are in a position to carry these securities till a favourable position comes for selling them either by utilising their own resources or their credit. On the other hand a corporation does not possess all these advantages for selling securities direct to the public. It has no organisation or equipment. It has to rely on news-papers advertising to discover its customers which is a very expensive manner. The banks are not prepared

to lend money on such securities. The cost of selling in this manner will be much more. Therefore, from every standpoint the attempt of a Company to market its securities direct is likely to prove unsatisfactory or unsuccessful. The cost of selling in this manner will be much more, the results uncertain and the risk great. Although sale to a banker is advantageous to the Company, but bank will not purchase every kind of security. They will have to sell to customers and the securities must be such as will appeal to the investor. So they should be investment securities rather than speculative securities.

The *requisites* of an investment security are :—

(1) An established business (2) efficient management (3) assured profit (4) conservative distribution of profits.

If any of these characteristics are absent from a business its securities are not entitled to investment ranks, because there is no guarantee to the investor that the income, on the basis of which he buys the stock, will be permanent. On the other hand the characteristics of speculative securities are the exact opposite of the distinguishing features of an investment. If a company is a new enterprise or the efficiency of its management is doubtful or it has not yet come into a stage of profitable operation or if it has made profits and has not distributed them to the stock-holders or finally if it has paid out too large a percentage of profits so that it has been obliged to suspend dividends when earnings decline its stocks must be regarded as *speculative*. The distinguishing characteristics of investment is that its value is founded upon certainty while the value of speculative

security is built upon unstable foundations of possibilities, suppositions and circumstances which cannot be known and the future only can reveal them. These two classes of securities correspond broadly to the characters of people who buy them. The investor will not buy a security whose value is doubtful. He demands in a security the virtue of a stable value. He wishes to be certain that his principal is safe and there is certainty of income. He is satisfied with a moderate return.

When an investment banker is approached by the promotors of a new company and is asked to assist in the floatation, he examines carefully the character of the scheme. The first thing he looks at whether it is saleable or not because unless he can sell them at a profit he will have nothing to do with the scheme. Assuring that the securities are saleable the next question is, can he recommend them to his own customers? He has an extensive organisation to sell. He may be able to push them on to his customers but he aims to cultivate goodwill which is the foundation of a business. At the same time he expects to be permanent in business. He has, therefore, to emphasise upon the safety of securities which he offers and recommends to his customers. His constant wish is to protect his customers against loss. A man in such a business can never recommend or sell speculative securities. If the securities of a new company are of a speculative character the banker will not purchase them directly for offering them to his clients. Such securities will have to be sold direct to the public and the bank or a trust company may purchase them at their own risk.

Sale Of Speculative Securities.

They have to be sold direct to the speculative public which is composed of persons of moderate or small means who are willing to buy the shares of new companies at low prices trusting in the representation of those who advertise their sale by saying that these stocks will pay large dividends and eventually increase in value. The speculative buyers have usually no knowledge af finance or do not understand the nature of investment judgment. They have no skill in off-setting advantages with disadvantages. Great care must therefore be taken to give the most simple and favourable information concerning the securities which are meant for them. The public is mainly concerned with the standing of the officers and directors of the company and the amount of the dividends which is promised to its share-holders.

There are few principles which should be borne in mind in selling the speculative securities. The first thing is to excite his imagination. A picture of enormous wealth in which he is invited to share is placed before him. He must be told to disregard the present and look into the future. In view of this the arrangement of the prospectus should aim at this. The reasons for believing in the future prosperity of the company should be given clearly. Example of similar floatations may be quoted. Strongly worded testimonials may be added for evidence and finally, he may be assured of high dividends. To prove this the examples of the record of other enterprises which had at their outset no better prospects may be given in evidence. In some cases it is desirable to give a detailed account of the future demands of the

products. In short the advertisement or the prospectus issued by the promotors who may be quite honest in their belief must be such that the speculator may be worked to the point of shutting his eyes to the risk and going in on faith only. The promoter will have to appeal to the imagination and they will have to blindfold the judgement of the people who are asked to purchase the speculative securities.

Role of Stock Exchange in Marketing of Securities.

There are various ways in which a new industry may be able to get the necessary finance. In the first place new economic development may take place through the expansion of existing undertakings. It means that an established concern may build up large reserves and utilise it in expanding its existing business or it may use its own financial connections for raising capital for new enterprise. In India the Managing Agents are important agencies for undertaking new developments of existing industries or new industries. Secondly, where a new enterprise cannot depend upon the support of an established concern the necessary capital may be subscribed by those who are prepared to take a personal interest in it. It means that the enterprise has to depend primarily on private capital. It is generally started on a small scale and after it has achieved success it may be converted into a Joint Stock Company and then necessary capital for expansion may be subscribed by the public. This was the course followed by the Managing Agents in the initial stages of the industrial development. In the third place new capital may be raised through the machinery of stock exchange. Although the stock exchange market usually attracts gteat attention as a

mechanism for obtaining new capital, its value to a new industry is insignificant. Stock Exchange is primarily an institution for imparting marketability to securities and to a very limited extent it is an institution for providing new capital for enterprises. However, it enables established enterprises to make their securities marketable. It provides markets for the purchase and sale of securities and it enables Joint Stock industrial enterprises and specially those already established to raise the large capital required by them. Stock exchanges provide facilites for industrial development and play an important part in modern industrial organisation. The study of the stock market in India deserves special notice as in the absence of other financial institutions such as industrial banks, Issue Houses, Investment Trusts etc., the Stock Exchange is the only institution which facilitates the mobilisation of individual savings and make them available for industrial enterprises. It is interesting to learn the services rendered by the stock exchange.

The Stock exchange is not an investment institution supplying capital funds to the industrial enterprises. It is only an intermediary. It provides a continuous and open market for the purchase and sale of securities. The public invests in industrial concerns because they know that if they want to cash their investment they can do so with the assistance of stock exchange. Without this facility capital would be immobile and industries would find it very difficult to raise capital and the investors would be afraid to invest their capital in industrial securities. The second service rendered by the stock exchange is that it enables investors to know the price of their securities from day to day. Quotation service is given by the exchange. From the quotations the

investors are in a position to know not only the present worth of their securities, but also their prospective value and thirdly, it directs the flow of capital from unprofitable to profitable industry. From the study of the quotations the investors are in a position to judge as to which industry is profitable and which is not. In this manner it helps the capital resources to be used more efficiently. Still another important advantage is the service rendered through the listing of the securities. It means that before the securities of a company can be dealt in on the stock exchange they must be listed for which they must meet certain requirements of the stock exchange authorities. By including in the list of securities the exchange does not guarantee the value of the earning power of that security but the fact that it is listed goes in favour of its soundness, as the stock exchange admits a company to its list after a thorough examination of the conditions of the company. Further, listing gives the securities the benefit of free market provided by the exchange. The purchasers and sellers of such securities are given the protection and safeguards of the exchange as regards brokerage and other procedure employed in the exchange of securities. From the Company's point of view listing has also certain advantages. They get the benefit of having their securities given a daily quotation from which they know the real worth of their business in the eyes of the public. If the investors think these securities attractive and profitable they can invest their capital in them. Without the quotation neither the company nor the investors are in a position to know the real worth of the company. In fact the companies are

always anxious to have the securities listed and usually they state in the prospectuses, for the information of the public, that an application will be made in due course to have the companys' securities listed on the stock exchange.

Having seen the importance of stock exchange we may consider particularly the position of the stock market in this country. Considering the vast size of the country there are very few stock exchanges in India. The most important stock exchanges are at Bombay and Calcutta. There is also a stock exchange at Madras. There are also less important exchanges at Cawnpore and Lahore, but these are of very minor importance. The only important stock exchanges which may be considered more organised are at Bombay and Calcutta. Even in these stock exchanges the methods of business are inefficient and defective. The stock exchange of Calcutta has got more defects than that of Bombay. The Calcutta stock exchange specialises in Jute, Coal and Tea shares. For other shares the market may not be considered as a free one. The stock exchange official quotations are not reliable. They are misleading to the public. Some of the members are speculators pure and simple and these people have converted the stock exchange into a gambling place. The blank transfers are very common. There are no settlement days. It is unfortunate that the stock exchange of Calcutta should conduct its business on unbusinesslike lines. The Bombay stock exchange is now regulated by the Act of 1925 under the supervision and control of the Bombay Government. There have been many corners on the stock exchanges

and several committees have been appointed to examine the rules and regulations and to make recommendations to improve the conditions of investments on the stock exchange. At any rate it has maintained its reputation as a responsible body and continues to provide good facilities for investments. These stock exchanges have served a useful purpose by directing the flow of capital to industry and by providing a market for the purchase and sale of recognised shares and debentures. They have not been able to touch the large number of small investors except indirectly. It means there are absolutely no stock exchange facilities for investment in industrial securities in other places. It is very difficult to say as to whether more organised stock exchanges be established preceding the industrial development or they should follow the industrial development. It has to be recognised, however, that investment in India is restricted to a small class of investors mostly in cities and that smaller investors have no chance of getting into touch with any reliable member of the stock exchange, the bigger share-holders come from the major cities like Bombay and Calcutta. The banks or any other institutions are not in a position to advise and assist as regards investments. The small investors who have tried to invest in industrial concerns directly have found their confidence shaken by the failures and lack of success of many a small industries. If more stock exchanges are established in important industrial centres the investors in those places may be able to get the opportunities of advice to invest their savings. It must, however, be emphasized that if more stock exchanges are established in this country whether with or without state aid they must be under

the control and supervision of the Government. The committees of management of these exchanges should be composed of the representatives of Government commercial bodies, Industrial concerns and Banks. Further, the listing regulations of these exchanges should be scrutinised and sanctioned by the Governmeut which should, at the same time, exercise supervision over the listed securities. This will naturally create confidence in the minds of the investing public and enable them to invest their savings in industrial securities.

Capital for a new industry may be raised by public or private subscription of shares. The capital required for a modern large scale industrial concern cannot be supplied by one or two individuals. It has got to be raised from a large number of persons. The corporate form of industrial organisation has made it possibe to raise funds not only from a large number of people but also from people of different temperament. It is possible now to raise funds from the greatest risk taking persons to the most cautious one by issuing securities bearing different degrees of risks. The securities by which capital is raised may be divided into two classes. The one representing Ownership and the other representing 'Creditorship.' The securities under each of these two may be divided into numerous securities–classes and sub-classes. The securities which represent owners' right can broadly be divided into two classes :— (i) Stocks and (ii) Shares. The Stock is differentiated from Shares by the fact that it can be divided and transferred in odd amounts. The Shares on the other hand, are expressed in different amounts and are not divisible. In practice, Stocks are bought and sold in round amounts. There is also some

difference in the methods of transfers of these securities. The dealing in stocks is not complete unless they are registered. It is therefore, more difficult to transfer stocks. The Stocks are an uncommon form of securities in this country. It is, however, far more desirable to have such a form as the conditions are quite suitable for having it. It will check speculation in shares because it has to be registered and is, therefore, more difficult and expensive to be transferred. Secondly, as it is not divided into exact fixed amounts it becomes inconvenient for speculation, and thirdly, its purchase or sale can exactly be adjusted to one's pocket. The disadvantage is that the investment in it is not as liquid as in Shares.

The Stocks and Shares are divided into three main sub-classes (i) Ordinary, (ii) Preference and (ii) Deferred shares. The simplest form is Ordinary shares. All the holders of such shares have voting rights and participate in the profits of the company in proportion to the amount of capital that they own. The denomination of ordinary shares is an important question specially in this country. One general rule is that it should be fixed at a figure which will appeal to the type of buyers who are to be approached. If we look to the denomination of shares issued by the Indian companies we find that in Calcutta the shares are of small denominations while in Bombay they are of large denominations. The reason is that in Bombay the capital was subscribed by a few wealthy persons and the denomination was kept high. In Calcutta the companies ware started by Europeans and the capital was subscribed by a large number of Europeans in small lots. Further, the Calcutta business men were

more experienced and they realised the importance and advantage of small denomination of shares. If the general economic condition is taken into consideration the shares of small denominations seem to be better fitted to India, Further they are more suitable for speculation. However, shares of very high denominations i. e., Rs. 100/- or more are not suited to middle class investors. It is obvious that larger the denominations the more restricted becomes the field of drawing capital for industries. Besides, shares of large denominations cannot utilise small savings even if they are issued and payable by instalments. The instalments are large and can not be paid easily. It does not mean, however, that smaller the denominations greater the advantages. There is always a limit. The smallness, when goes beyond that limit, becomes more harmful than beneficial. The advantages of shares of small denominations are reaped when the shares are issued honestly. But we find that honest purpose does not exist. Shares of very small denominations are ually issued by the organisers or speculators and unsound enterprisers and are sold to those who are ignorant investors and fall a prey easily to the bright description of the future of the enterprise. When the shares are not of too small denominations they are to be sold to higher class of people who can form their opinion about the soundness and prospects of the scheme and hence the possibility of corruption and swindling is less. It is therefore, important to protect the investors if the shares are to be of small denominations i. e., to say the issue of small denominational shares should be foolproof. So long as it can not be achieved it is better that the ignorant investors with small means

should be protected from wasting their savings on unsound schemes by keeping such investments outside their easy reach. It seems desirable that shares of denominations smaller than Rs. 10/- should be prohibited under present circumstances.

Preference Shares.

There are two main classes of Preference Shares i. e., Cumulative and Non-cumulative. The Preference Shares may also be Participating Preference Shares. The popular type of Preference Shares in India is that of Cumulative Preference Shares. The Preference Shares are designed to meet the want of investors who wish for certain, though small yield on their savings. They do not want to take the same risk as is involved in the Ordinary Shares. This certainty of return on the Preference Shares is only comparative. In cases where the arrears extend over a number of years and the preference share-holders claim their arrears, they run the risk of ruining the concern altogether. Leaving out such extreme cases the cumulative preference shares usually bear less risk than the ordinary shares. Non-cumulative Preference shares are issued rarely and are not so safe. The situation that is found in India in this respect, is some what peculiar. In the first place, Non-cumulative Preference Shares are very rare and secondly, they enjoy the voting rights similar to those of ordinary Shares. This is an advantage from the point of view of management specially under the Managing Agency system. The Managing Agents thereby can adjust their investment in such a way that they can keep the control in their hands without undertaking any great risk. They can also change their holdings of

ordinary and preferred shares according to the prospects of profits according to each of them without affecting their control. As Preference Shares enjoy voting rights the Managing Agents are tempted to issue a comparatively large number of Preference Shares. When the Managing Agents become interested in the Preference Shares they become careless about the interest of the Ordinary shareholders. It has a bad effect on the efficiency of management. Really speaking there is no reason why the preference shareholders should have any voting rights. Their interest are not likely to suffer if they have no voting right as they must be paid in priority to ordinary shares. If the preference share-holders are deprived of the voting privileges, they must be given a better legal protection than what they enjoy at present. For example, in U. S. A., where they do not enjoy the voting privilege protection is given on the following lines.

Provision is made for the maintenance of the company's property in first class condition by proper depreciation allowance and insurance against losses. This is desirable otherwise the preference shareholders will get only the fixed rate of returns while the assets may be dissipated in giving dividends to the ordinary shareholders. Secondly, there must be restriction with regard to the selling of the assets or changing the character of the business and thirdly the company should be prohibited from issuing new Preference Shares. The denomination of Preference Shares is higher than that of Ordinary Shares. As a matter of fact the greater the security the lower should be the denomination. Because the poorer investors may be able to purchase such securities.

The situation in this country is quite the reverse i. e., the greater the security the higher the denomination. The result is that the small investors can not avail of such securities. If they desire to make use of their savings, the industrial paper with greater security should be issued in small denominations. It is, therefore, advisable that the denomination of preference shares should not be more than Rs. 25/-.

Redeemable Preference Shares.

This is a new form of share, provision for which has been made in the Company's (amendment) Act although they were very popular in America. They have not become popular so far although they will prove of great benefit in India. This is very convenient way of securing a working capital and will be found of great utility by prosperous concerns who do not wish to borrow funds which may employ uncertainty and high costs. The charge will not be permanent, they can be redeemed from the profits made by the company. Further, such preference share-holders being not the creditors cannot trouble the company like debenture holders.

Deferred Or Founder's Shares.

These shares participate in the profit usually after the ordinary shareholders get a certain percentage of dividends and are generally taken up by the original promoters and vendors. In India, these shares are taken up by the Managing Agents and the Directors. Although in other countries they may be given to the managing staff with a view to encourage them. If the same thing is done in this country the officials of the company will receive an extra incentive for efficient work. When the deferred

shares are held by the Managing Agents and the directors they are likely to be inconsiderate in declaring profits in order to secure and justify dividends on deferred shares. This is detrimental to the interest of the ordinary shareholders. The deferred shares are used by the Managing Agents as a device of keeping control over the company with a relatively small stake. Such shares are usully of very small denominations and are issued in consideration of promoting and organising services. The result is that the interest of the ordinary share holders are likely to suffer where such shares exist.

No Par Stocks.

This is very popular in America but not found in India. It is a stock without a par value. Its value is not stamped on it but depends on the value of the issuing company. A stock certificate simply shows that the owner is entitled to a certain portion of the assets of the business without any statement of the money value of each share. The total capital or assets of the company are divided into a certain number of shares and each share represents a proportionate part of the total assets. It has certain advantage of having greater flexibility. The company is in a position to sell its shares at different prices according to the general financial and business conditions of the time. There is nothing like selling at a discount or at a premium. There is no fixed price or the face value. Their price does not attract attention. The innocent investors are protected because they cannot be pursuaded by speculators or swindlers to purchase them as bargains at low prices. The No Par Stocks suit the Indian conditions very well. In America No-Par Preference Shares are

also issued, but they are not popular. However, the No-Par Stocks give great scope to manipulations of accounts and hence the investors must be able to exact sufficient and accurate data on the financial affairs of the concern to understand the same. Where the investors are not able to safeguard their interest it is better that this stock may not be issued unless there are sufficient legal checks upon the activities of the management.

Creditorship Securities.

There are two main classes of creditor's securities: (1) Bonds and (2) Debentures. The former is security by mortgage on specific properties or by the deposit of other securities in the hands of trustees. They are very common in U. S. A. The debentures, on the other hand, for their security, depend only upon the general credit of the issuing company though there are many provisions and restrictions for the protection of the debenture-holders. The process of issuing them is almost the same. In the first place there is a document which is an agreement between the company, the holders of the securities and the trustees. The trustees are intermediaries between the company and the bond-holders or the debenture holders. These separate bonds or debentures have to be issued to each of the investors as a separate evidence of debt. The agreement specifies in detail the obligation of the company, the duties of the trustees and the rights and privileges of the investors. They are issued against the assets and the repayment of the principal becomes secured and on default the assets can be attached. Debentures in Indian industries are issued chiefly in the following forms although debentures are not very common or popular in this country.

(i) Registered Debentures, which are transferable only by deed. They are not very common as their issue and transfer is expensive.

(ii) Bearer bonds transferable by delivery, and

(iii) Bonds transferable by endorsements.

All the debentures issued are redeemable and a sinking fund has to be created for their redemption. Bearer bonds are more popular. It has to be admitted that industries in India have not raised sufficient capital by way of debentures or bonds. Various reasons are forwarded for the relative unpopularity of this type of industrial paper. The speculative tendency of the Indian investors who prefer an investment having prospects of capital appreciation is the most important reason. Seeondly, the debentures are purchased by Indian Princes or big landlords who hold them as permanent security, e.g., when Tata Iron and Steel Company floated debentures to provide itself with working capital the entire sum of 60 lakhs was subscribed by the Maharaja of Gwalior. Thus a market is never being created in debentures and people with moderate means do not get any chance of investing. The creditorship security have still a great potential market for them. In addition to small investors there are insurance companies which are also in a position to invest in debentures but owing to lack of confidence in the stability of the industrial enterprises or owing to the inconvenience created by the lack of market they seldom invest. Another reason is the creation of the industrial concern themselves. From the point of view of the companies the debentures have certain disadvantages. They are secured against the assets and they

affect the credit of the issuing concern in the money market. The result is that the banks which supply short term finance curtail their advances. It means that a company which issues debentures finds its credit weakened in the eyes of the banks. The shares of such a company which is encumbered with a debenture loan has not the same full credit as one without it. Because the security for bank credit is less. This attitude of the banks must change and the banks must take a more active part in helping the industrial concern with advice and by cooperating with it in the issuing of debentures. Another reason is that debentures are not issued in the most attractive way with a view to tempt the investors. Whenever debentures are issued they are issued in such large denominations that they are beyond the reach of the investors with moderate means. Further, a very few forms of debenture issues are known in this country while in other countries a great many forms of debentures are issued e. g. debentures may be convertible into shares or debentures may be issued with a high premium at maturity. Another reason may be, that in this country Government securities are popular as they possess attractive features for investment. Debentures must compete successfully with them. In conclusion it may be stated that efforts should be made to popularise debenture issue.

The following methods may be suggested :—

(a) By making them more attractive and holding out redemption at premium.

(b) By offering more freely the right of converting them into Shares

(c) By removing the prejudice of the banks

against companies which have issued debentures.

(d) By greater cooperation between banks and industries, and

(e) The debentures should be issued in low denominations.

There may be risk in that but there should be efficient service rendered by the trustees to the investors. The investors must be confident of the fact that their investments are sound and they purchase with confidence. For this purpose there should be good agencies for doing the work of the trustees who should be interested in the success of the issue offered under their trusteeship. In this country the trustee business is in the hands of a few influential bussinessmen or managing agency firms. In fact the debentures are purchased by big companies in large lots and they are carefull of their own interest. The trustees become unimportant. If a large number of investors are to be interested it is necessary to have efficient and honest trustees to protect the interest of the investors. In America, investment banks render this service. In Great Britain, financial institutions render the necessary service in this connection. In India there is no institutional financing i. e., there are no institutions to sponser the sale of shares or debentures and the public underwriting of new issues is an uncommon phenomenon in this country. This is due to the presence of the Managing Agency system. The Managing Agents themselves supply the necessary finances when they sponser any new undertaking. Underwriting becomes less important. When any new issues are underwritten it is done by stock

brokers. In the absence of the agencies for sponsering new issues and where necessary finance is not provided by Managing Agents, new companies have generally to raise capital by offering shares or debentures to the public for sale by means of public advertisements. The debentures have a very limited market in this country. Only such debentures which are issued by companies managed by good managing agents are readily taken up by the public. In the case of new or recently started undertakings debentures as a means of raising capital are of little value unless their interest or principal or both are guaranteed by public authorities. However, it is a peculiar feature of this country that the debentures with all their advantages have not been very popular.

Advantages.

The debentures give the greatest security of capital. They are fixed interest securities. The principal is secured. If the interest is not paid regularly the trustees may have the assets of the company auctioned if they like. They are redeemable at a known date. The price of the debentures is usually stable and the changing monetary conditions affect the price movements negligbly. Then the accumulated interest on debentures can be taken as a loss in business for purposes of income-tax. The income-tax is not deducted at source and the small holders are saved from the botheration of applying for refunds for income-tax. These are the obvious advantages but there is another important advantage which the debentures possess—the existence of the debentures as part of the capital keeps a healthy check on the extravagance of the Managing Agents

and thus limits the loss of the company. If the loss exceeds a certain limit the debenture-trustees if they are vigilant and are not in the pay of the Managing Agents, will atonce pounce upon the company thus saving it from further loss. A prosperous company can raise the necessary capital at the cheapest possible rate giving at the same time the greatest security. On the whole it may be said that in the capital structure of public comany in this country, debenture should be given a more important place. The combination of debenture with ordinary capital is the best. Cumulative redeemable preference shares are equally good provided they are issued during the period of boom and are redeemed within the period of boom from the profits made by the company. Such capital structure is in the best interest of both the company and the shareholders or debenture-holders.

LECTURE VI

Supply of Short Period Capital.

Besides the finances required for long period mainly to secure the fixed assets, businesses require additional amount of capital known as working capital to meet their current expenses, such as purchases of raw materials and stores, payment of wages, salaries, rents, expenditure for marketing the goods etc. These charges must be met as recurring expenses. The working capital is usually obtained by three methods. Some concerns make a provision for working capital along with the capital required to secure the fixed assets, while others reinvest their earnings or their profits in the business. These two methods are very popular both in Great Britain and U. S. A. The first method i. e., by issuing shares or debentures is employed by new concerns which obviously cannot adopt the second method. The second method is adopted by the established concerns. It may be considered as best method for finding the working capital as well as the fixed capital and capital required for replacement of plant and machinery etc. The third method is by short term borrowings. It is known as such because the capital is not needed permanently. It is required for the short period to meet the temporary financial requirements of the business. It is not very frequently used in the western countries and is resorted to only in cases of emergencies. In this country the first two methods are not used commonly while the third method, i. e., by short term borrowings is very common. The short term borrowings by Indian industries is made from four main sources. (i) Public deposits, (ii) Managing Agents, (iii) Bankers and

Financiers, and (iv) Banks.

Public Deposits.

Public deposits in the Indian concerns have been an important feature of industrial finance in this country. The system in its origin may be said to be the outcome of the old system of money kept for safe custody with the Mahajan. They have been very popular in Ahmedabad and Bombay. If we compare this finance with the finance supplied by the banks, we find that 9% of the finance was supplied by the banks while 11% was supplied by public deposits in the case of Bombay. For Ahmedabad the banks supplied 4% as compared with 39%. It is obvious to appreciate the importance of public deposits as a method of finance. In fact some of the mills have got deposits in excess of their paid up capital. It is no doubt true that these deposits are not so popular now, which is due to the fact that the confidence of the public in the financial position of the Managing Agents is shaken and the securities are offered by the Government of India and other public or semi-public bodies which may be considered more safe from the income as well as capital point of view. They have not been so popular with the European concerns and the reason may be that the European Companies are floated with the share capital which is sufficient for both fixed and working capital and secondly, they have been able to obtain necessary funds from banks in the shape of loans and advances. The deposits are always obtained as unsecured loans i. e., no security is offered and the public have to depend for their repayment on the standing of the concern and reputation or financial position of the Agents. They are accepted for 6 months

or one year and may be renewed thereafter. Although deposits are taken even for as long as seven years in which case they cannot be considered as short period deposits They are meant to meet the capital expenditure at the same time. The rate of interest naturally depends upon the credit of the Agents and their financial position or of the concerns. Concerns with good financial position and reputation may attract large amounts at low rate of interest. The rate of interest is usually between 5% and 6%.

The deposit system of finance has some defects. Firstly, it is very inelastic. The inelasticity arises from the fact that they cannot be attracted or paid back according to the needs. The deposits cannot be returned if the money lies idle and they can not be attracted in time of need if the public are reluctant to give, they are inelastic as compared with the bank loans which can be reduced or increased according to the needs. They have to be considered inelastic as well as uncertain. The money may be withdrawn at any time causing great inconvenience to the concerns. During the prosperous times the public are quite willing to give deposits while in the period of depression when money is needed most to tide over the difficulty they may be withdrawn. Another defect of the system is that its cost is high. The majority of the concerns excepting those which are well established and well known have to pay high rate of interest on their deposits which is much higher than the interest charged by the banks. Secondly, some of the concerns may like to keep the deposits even if the money remains idle with the consideration that it may be required in emergencies when it may be

difficult to get the deposits. The deposits have again some defects from the depositor's point of view. Some of the depositors may not be able to determine exactly the financial position of the concern and thus may lose money. The deposits being unsecured have to be paid after all the secured creditors. The depositors being unsecured creditors cannot prevent the directors of the concerns from indulging in speculative activities or from otherwise mortgaging the assets of the concerns for loans obtained from other sources. Another defect, which affects the position of the depositors is that some industrial concerns use the deposits to finance their capital expenditure. Inspite of these defects it has to be admitted that the system has been found very useful and is well suited to supply short term finance. There has been a general complaint that banks in India do not interest themselves in rendering financial assistance to the industries in the forms of loans, advances and cash credits. The banks impose restrictions and conditions in rendering services. The industries, therefore, cannot rely upon their support as a source of finance. Until, therefore, the banks take a greater part in financing, deposits have to be invited and used for the supply of short term capital requirements of business even if in view of other channels of investments by the public the rate of interest may have to be increased.

Managing Agents and Short Term finance.

The Managing Agents in India play a very important part in the financing of the working capital of a large number of industries. As Bombay and

Ahmedabad depend to a great extent on the Managing Agents for their current finance. They are reluctant to avail of the facilities provided by the banks. In other parts of India assisstance is given by Managing Agents even in respect of their current finance to other industries. The advantage of such a system is that it is easy to obtain the loan from the Managing Agents, where the third parties are not required to guarantee the loans and the rate of interest usually not exceed the bank rates. There are also certain disadvantages. In the first place, it may be considered as a very uncertain source of finance. The resources of the Managing Agents may be limited and the industrial concerns may not be able to obtain from them the necessary finance in the time of need. It specially happens during the period of depression when the industries suffer and the Managing Agents who are not making profits and their recsources are limited are not in a position to advance the necessary amounts. The matters are made worse by the fact that the weakened financial position of the Managing Agents reacts on the concerns and they find it very difficult to obtain funds either from the public or the banks. Second disadvantage is that the Managing Agents owing to its being a good form of investment, are tempted to lend larger amounts than necessary. It may lead to surplus funds lying idle and may be used for speculative activities by the management. Another disadvantage is that it is a costly method of finance. In some cases the rate of interest charged by the Managing Agents is high. It may be due to the fact that the Managing Agents who are unable to supply their own finance have to borrow either from the

public or banks and then lend the borrowed funds to their concerns at a higher rate of interest. They may also charge commission. And lastly, although the Managing Agents take no guarantee for the money lent by them they are careful to safeguard their interest. As soon as they find the concern in difficulty they convert these unsecured loans into debentures and thus they have charge over the assets of the concerns. In this country borrowing short term finances for working capital from the public and the Managing Agents are quite common inspite of their disadvantages.

Managing Agents & Industrial Finance.

Industrial financing is in India so intimately connected with the system of Managing Agents that it is worthwhile to examine the nature of the financial assistance rendered by the Managing Agents. We may also discuss the merits of such financing and its drawbacks. The banks in this country are not prepared to finance the long-term needs of industry i. e. block capital and are not able to provide more than the circulating capital for short periods to industry. Even in doing so they want not only the security of materials and stocks of goods and the signature of a mill-comany for any loan but also require in addition the signature of two persons which means the guarantee of the Managing Agents in personal capacity. It may, therefore, be said that the Managing Agents have not only to look to the satisfactory working of the mills but to finance them. When the company is started the initial capital is subscribed by the Managig Agents or their friends. When the industries were first started in this country

the Managing Agents undertook to supply both the fixed capital and working capital. It was due to the peculiar nature of the money market then existing. There were no banks, and the moneyed classes were reluctant to invest. So they had to supply to a great extent the Share capital. Although the conditions have changed and the public has become acquainted with the industrial investments and they are prepared to invest in any sound scheme floated by the reputed businessmen. With this change the Share of the Managing Agents has proportionately decreased When the company is promoted the Managing Agents. and their friends may subscribe 60 to 70% with the object of having a control over the affairs of the company and to demand special consideration in the enterprise. This small group of original subscribers do not hold their Shares permanently. Such Shares are unloaded on the market and are purchased by the general public. The initial subscribers get a commission of 2 to 5% of the nominal value for subscribing or agreeing to subscribe the Shares which at a better stage are sold off at a premium. They can manipulate the prices of the Shares with the knowledge of inside working of the capital. Ultimately the normal holding of the Managing Agents comes to between 10 to 15% of the total Share capital. Their control with the companies have been executed in the earlier stage. There is no danger or risk afterwards. The Managing Agents thus initially subscribe a large proportion of Shares not because they are not willing to allow it to be subscribed. The shareholders who came later on have to suffer. This has naturally resulted in under-capitalisation of the concerns. A firm may be said to be

under-capitalised when the total capital invested in and available for the enterprise is inadequate to its total needs or when the permanent needs of a concern sought to be met by the fluctuating supply of funds either from the public or from banks. On the other hand, over-capitalisation which is converse of under-capitalisation means that there is a redundance of real capital invested in a concern in such way that it is not needed there. When the total value of the capital is in excess of the surplus assets of the concern including the value of the goodwill or where the profits of the concerns over a period of years are too low in proportion to the amount of nominal capital waiting to earn dividends there is over-capitalisation. Over-capitalisation may be brought about by inflating capital during the period of boom or by issuing bonus Shares. There are great dangers of over-capitalisation. The defects of under-capitalisation are more apparent. The concerns which starts with an initial lack of capital places itself under handicap. Under-capitalisation is the result of financial weakness. A common argument put forward in favour of this policy is that this is more economical to finance by borrowing, as the borrowed funds may be obtained at 5 to 6% which is much less than what would be paid to the Share-holders as dividends. This method which has resulted in under-capitalisation was the result of the peculiar circumstances of business conditions of the last century. The less the amount of Share Capital the greater are the percentage of returns on it. The total investment in each case was not large. The necessary funds for working

were supplied either by the Managing Agents themselves or being themselves wealthy they could attract sufficient money at low rate of interest. It works better in the case of large companies because the big concerns owing to the high credit find it easy to borrow money at low rates. It is more dangerous in case of small concerns, as they have to offer high rates of interest and even then they find it difficult to get sufficient funds. Even big concerns now find it more and more difficult to get money at a low rate and in sufficient quantites. The people now deposit their savings either in Government paper or with banks or invest them in landed properties. In this manner under-capitalisation has become a common feature of the finances of our industrial concerns. The working capital is obtained by the companies in 3 ways: it is either supplied by the Managing Agents in the shape of loans or loans from banks on the guarantee of the Managing Agents or thirdly public deposits. The ability of Managing Agents to finance from their own resources is limited by the size of their purses and at present times the needs of the clients concerned managed by the agents has increased. The individual concern has become enlarged and the number of concerns under each firm has increased. The resources of individual agency firms have to be divided among many concerns. Whatever the amount which may be advanced, the fact remains that the financial backing of the Managing Agents is often required to save the concern in difficult times. This is due to the fact that some of the Managing Agents have such a high sense of self respect and pride that they would not allow their name or credit to be easily shaken or impaired. Once they have taken the

responsibility of promoting the concern in such period of depression the managing agents supply the necessary finances to save the concern from ruin. The agents sometimes, incur heavy losses from such financing activity. Even in most difficult times they are prepared to meet the financial needs of the concern. The help rendered by firms can be much appreciated if we understand the faulty system of the industrial finance in this country. If the managing agents do not come forward with their advances it will be very difficult for such concerns, to tide over the adverse period. It cannot be denied, however, that the help rendered is in their own interest. They hope that the benefits of the Managing Agency will continue to accrue to themselves and to their successors. These loans are, sometimes, converted into debentures and these debentures make them a permanent burden on the business.

(3) Indigenous Bankers and Short term Finance.

Majority of the business concerns who are not in a position to get their current finances from the Managing Agents or banks, have to borrow from indigenous bankers, moneylenders and individual financiers. They have to pay a high rate of interest which is usually very heavy, sometimes inexorbitant in the case of moneylenders. The rate of interest varies from 15% to 36%. It is not only the small concerns who resort to this method but sometimes even the well established concerns have been found borrowing from individual financiers including Indian princes, e. g., Tata Iron and Steel Company in order to meet its working capital requirements was forced to issue debentures, a large block of which was taken up by

the Maharaja of Gwalior. In Ahmedabad, the cotton mills obtain substantial assistance from the local shroffs.

(4) Methods of Bank Advances.

In Europe and America, banks play an important part in this respect. Unfortunately, in this country the banks assume a conservative attitude towards industry. Let us see how far the banks can help the industries by providing necessary short term finances. The following methods are usually common for obtaining advances from Banks :

(i) Advances against tangible and marketable security lodged or pledged with the lender.

(ii) Advances against personal credit with the second signature to the pronote and

(iii) Advances against the personal credit of the borrower only.

Nos. (i) and (ii) are very common in this country although there are many defects in the system and practices followed. Advances under the first class are made on such securities as stocks, merchandise either manufactured or semi-manufactured. The banks maintain a margin of about 25 to 30%. The goods have to be deposited in the godowns or warehouses of the banks or in the godowns of the borrowers under the letter of hypothetication to the lending banks. Advances under the second class are made against the personal credit of the borrowers with the second signature to the pronote. The second signature may be of the Managing Agent, Managing Director or a director as a guarantee for the repayment of the loans. Cash credit system is most popular method of

giving advances to industrial concerns. Under this system an advance is allowed against the promissary note secured by the hypothetication of stocks. The system is advantageous both to the banker and borrower. The borrower pays interest on the amount actually drawn by him, although he has to pay certain interest on a minimum which is usually half the amount of his drawing power. He can reduce his obligation at any time. The banker has the advantage of reducing or withdrawing the facility allowed to the borrower any time he choses.

The general attitude of the Indian banks towards industry has been criticised. Their practice in the matter of grants of even the limited advances is open to greater criticism. When advances are granted against tangible and marketable security the banks insist on security of stocks. They take no notice of the fixed assets. On this they want a high margin. This has got an adverse effect on the industrial concern specially during the period of depression. Sometimes the banks want only raw material as security in preference to manufactured or semi-manufactured goods. The industrial concerns having large stocks of manufactured goods are unable to obtain accommodation. They have to sell at any price in order to realise cash. Again the practice followed in regard to hypotheticated stocks is open to objection if they are in the godown of the borrower. A weekly statement has to be submitted. If the banks possess a godown the borrower must remove the stock from his own godown to that of the bank every time the accommodation is needed. If he is in need of stock he must remove to his godown. For removing the stock

there is waste of time and money besides inconvenience caused. It has to be admitted that this procedure has to be adopted owing to the absence in India of licensed warehouses or other facilities for storing of goods. Some of the banks which do not maintain their own godowns refuse to grant advances and only a very few clients can obtain loans on the security of the goods in their own godowns. This method of obtaining loan by hypothecating stocks is not popular with Indian industrial concerns. It is objected to because the procedure involves a control of banks over them and this lowers their position in the eyes of the creditors or depositors and it becomes difficult for the industrial concerns to obtain finance by other methods. The system of such credit is not free from defects. The borrower has to pay interest on the minimum amount. Again the bank can control or withdraw the facility at any time it thinks fit. This uncertainty keeps the borrower in suspense, as regards the continuance of the facilities allowed to him. This is so specially during the period of depression as the value of the stock falls. The banks require more security or curtail their credit. Another defect is that the banks require two signatures on promissory notes. The Imperial Bank of India is forced by Law to demand two signatures. The other banks follow the practice. In doing so they do not take into consideration the credit-worthiness or the standing of the borrowers. As a result the industrial concerns, however, sound, are unable to obtain loans on their own security without the guarantee of the Managing Agents or another director. If the second signature is not forthcoming the loans are refused. In this manner the Managing Agents play an important part

in securing these deposits. In fact this has an adverse effect upon the financial standing of the Managing Agents. When the public comes to know of the fact they have no longer confidence in the financial standing of the Managing Agents and may begin to withdraw their deposits. The result is that the responsibility of the Managing Agents is increased and it is difficult to manage the funds necessary. Another defect in the banking practice is that no principles are observed by the bank managers in granting the advances. Personal favours, favouritism or prejudices are the guiding factors. There is no fixed rule or policy as regards terms and conditions under which loans and advances are granted. The manager is given the free hand in this respect. Another defect of the banking practice is with regard to payment of loans, advances and cash credits. It is said that they are too strict in demanding the repayment of their advances, on the due dates and that the banks do not renew the loans and advances for fresh terms. On the other hand the banks point out that they are always willing to renew the loans, advances for fresh terms although in theory they are strict in demanding repayment. Whatever the case may be there is always an element of uncertainty as regards the renewals which may be obtained at the discretion of the bank manager. The difficulty of the borrower is increased by the fact that the banks curtail or even withdraw the loans and cash credits before the end of the date. The industrial concerns are put to great difficulty. This attitude becomes positively harmful in the period of depression. The banks aggravate the situation.

Finally in our banking practices there is the absence of trade bills. Trade bills are an important source of advances to the industries by the banks. In India banking aid has been given mostly in the forms of loans and advances and cash credits and not by way of discounting the trade bills. The banks have not been taking this kind of business in hand. Recently a discount bank has been floated with the main object of rendering this service. Banking aid given by way of discounting the bills has special advantage. In the first place the advantage to the bank is that it is automatically reimbursed with the maturity of the bills. In the second place the industrialists or the manufacturers are in a position to obtain money by drawing trade bills and discounting them with banks. In this case there will be no promissory notes, guarantee of the Managing Agents or hypothetication of stocks. Further, he can sell his goods only when the market is favourable. Then he can get accommodation up to the full extent of the value of his goods. In the case of loans and cash credits a margin is kept by the banker. In the case of bills the uncertainty does not arise and the manufacturer has not got to depend upon the discretion of the manager who may refuse him the accomodation at the right time and lastly, under a well developed bill market it becomes easy and cheap to borrow from banks by discounting trade bills. On account of the liquidity and security banks are prepared to discount them at a lower rate than they charge in the case of loan and cash credits. Thus the discounting of trade bills must be encouraged by the banks who can always get them rediscounted at the Reserve Bank.

Suggestions for further improvement.

Till the Industrial Banks are established which should provide working capital in addition to fixed capital to industries, the Commercial banks can do much by increasing the provision of short term finance to our industries. If their resources are insufficient they should increase their Share capital. Firstly, banks should take up securities issued by industrial concerns to raise working capital and after holding them for sometime, sell them to the investors who will then readily purchase them. They should relax hypothetication rules. The high margin should be lowered. They must not stick to the six months rules of granting loans; it must be relaxed. There should be liberal policy with regard to repayment and renewals of loans. The banks should lend money on personal credits. In fact the policy of one company and one bank should be followed. The banks may have industrial service departments for finding out the cerdit-worthiness of their customers. In addition to that the banks should be assisted by independent credit investigation agencies. There is also a need of independent warehouses which should be licensed by Government and may be subject to Government Supervision, inspection and control and above all banks should discount trade bills.

LECTURE VII

Stabilization Of Profits.

Companies exist and do business to produce dividends for their owners. A company which has no prospects for paying dividends should be either dissolved or reorganised to a dividend-earning basis. After making the various deductions the surplus profits belong to the Shareholders. A dividend is a payment of the profits of the company to its shareholders expressed in the form of a certain rate percent on the par value of the Shares. There are two steps in the process of ditributing profits. Firstly, the directors by a formal resolution declare that profits have been earned and that they recommend the payment of such and such dividend. While declaring the profits the directors must consider the following:—

(i) The cash or the liquid assets of the company at that time which the dividends will be taken.

(ii) The prospects of the business for the early future.

(iii) The ability of the company to obtain any funds which may be necessary for new construction by the sale of new shares or debentures. These important considerations must be borne in mind even by the exceptionally prosperous companies, otherwise, the comany may find itself in financial difficulties in future. The law provides that the declaration of dividends is optional with the directors The Articles of almost all the companies contain a provision which provides that before declaring a dividend the directors have power to make such reserves as they think proper. Thus the directors of companies are empowered to determine the amount of current income to

be set aside for working capital and the amount to be distributed in dividends to shareholders. The directors being the trustees for the shareholders are given power to dispose off the funds of the company. They cannot be compelled by the shareholders to recommend or declare a dividend how large the amount of profits be. As long as they do not make any improper use of the profits, and leave the profits with the company until they decide to pay them to the shareholders, the shareholders cannot get any share of them. It is, therefore, clear that the company is not bound to divide the whole of the profits among the Share-holders unless the Memorandum or the Articles of Association make a clear provison to that effect. The directors have to decide what portion should be divided among the shareholders. They have to consider financial policy of the business with regard to the distribution of profits. It means that the directors must make certain provision to keep the investment intact and to consider the future expansion of the company. After meeting the requirements of different provisions, the surplus profits can rightly be divided among shareholders as dividends. Every company before proceeding to allotment of dividends must take into consideration the following points :— (a) What has been the past record of the earnings. (b) What are the future earning prospects ? (c) How strong is the company's position with regard to cash ? (d) What plans does the compay have for the future develoment of the business ? (e) Does the company tend to undertake extension of property with retained earnings i. e., reserves or with funds raised in some other manner ? After giving full and mature

consideration to the above questions and finding things satisfactory in every manner the dividends may be declared. The underlined principles of the dividend policy must be to retain stability of the dividend rate. It is highly desirable that the dividends paid year after year should be as far as possible uniform. The practice of fluctuating dividends by public companies is open to serious objection.

Advantages Of Stable Profits

It is in the interest of both—the shareholders and the company that the rate of dividend once established should be maintained. If the record of the company is consistent in this respect, its stocks will be good investment and will attract the public. The shareholder regards his ownership of a company's shares merely as an investment of capital that will bring him an income. The investor wants steady and stable dividend and he will be prepared to pay higher price for the shares which will yield him a regular income as it will enable him to adjust his expenditure to the income safely. A rate of dividend which is changed every year will disturb his calculations, will shake his confidence in the company. As a result of this, he prefers to purchase shares of a company giving stable rate of dividends. Consequently, shares with regular dividends can be sold at higher price. Besides, such Shares are highly valued as collateral securities for loans. Many companies have to borrow for current finance and they have lo keep strong financial position in the eyes of the bank. It is, therefore,

important for the company to maintain the value of the shares at a high figure. Further, a company desirous of improving or extending its business, may wish to raise further finance. It can do so on relatively easy and favourable terms if it has followed a sound financial policy. Even if the new shares have to be offered to the public, the prices obtained for them will depend upon the prices of those already issued. It means that stable dividend record improves the credit of the company and increases the value of the company's stock. From the point of view of the share-holders it is advantageous to follow such a policy because he can rely upon a certain income. If the dividends of a company widely fluctuate he is not in a position to know as to what his income would be from his holding an investment in such concerns. It becomes a sort of speculation. A stable dividend policy is, therefore, desirable for every company. However, a stable dividend policy does not mean an inflexible policy only but one that involves the payment of a fair rate of return taking into consideration the gradual growth of business. In order to maintain a reasonably consistent policy, it is highly essential that a company should be conservative at all times. Some financiers are of opinion that no dividends should be paid in the beginning even though earned. This should be postponed until the company is in a position to forecast definitely its future on the basis of past records. Every new company is in the experimental stage. Even if it is established on sound basis and has every chance of success its future cannot be predicted.

In every business, there are a number of factors which may affect its business or profits in the future e. g., new laws may increase the taxes and duties, or there may be changes in tariff, there may be depression in the industry or the competition may increase or the wages of the labour may have to be increased. All these factors tend to reduce the earning power of the company. The companies incorporated during the boom period have to take a particular note of these facts. They might have purchased the properties at an inflated price and there is an element of inflation in the capitalisation. During the boom period they are likely to miscalculate the future possibilities in their optimism of the factors affecting the business. The wisdom of such a policy or its practibility is rather doubtful. The shareholders usually are very eager to get dividends from the very beginning. In their opinion a small dividend is better than no dividend and a bird in hand is worth more than two in the bush. Under such circumstances if a company does not pay dividends for some years after its hard work the price of the shares will come down and its credit will be lowered. Many shareholders who do not wish to keep their holding as an investment but would sell them at any time when they need money or can get a higher price desire to secure a large return and do not wish to have the earnings withheld for the benefit of the future shareholders due to the financial stability of the company. They take a short and narrow view of the company's affairs and are more interested in their own income than in the company. In this manner the interest of the company and the interest of

the shareholders are not identical. In such circumstances whats hould be done by the directors. The answer is given by Pixley in his book on Auditors and is as follows:—

"It is not incumbent upon the directors to consider in any way individual shareholders, or special group of shareholders, and certainly not those who make a practice of buying and selling shares and holding them for short periods. It is their duty to keep the capital of the company intact and to do their best to make it a permanent institution."

The same view is expressed by Sir Rober Menzies, Chairman of B. I. C. Ltd., Cawnpore, at the Annual General meeting of the company held in 1943, when he said,

"Your directors in recommending that dividend on the ordinary shares should be maintained at 25% have had before them the fact that the period of recovery after the war should, as I have stated before, be difficult and costly, and further, that it was their clear duty to safeguard to the fullest extent possible the interests of what I might call, the bonafide shareholders of the corporation. I regard, it is not the director's duty to the same extent to safeguard the interest of the speculators who may be induced to buy or sell shares in public companies in circumstances involving a risk of loss or a possibility of a gain".

Under such circumstances, when there is a clash of interests the Directors should compromise. They must consider the future interest of the company by protecting and keeping intact the

property of the company and at the same time, they should see that no injustice is done to the present shareholders by concealing certain facts or information.

Another important consideration to which the directors should give attention is, that while declaring dividends they must take into account the cash at the disposal of the company at that time when the dividends are to be paid. In some cases dis-regard of the fact is a source of financial embarrasment. Many prosperous concerns showing highly satisfactory profits and paying good dividends have found themselves in financial difficulties. They have not realised that payment of dividend should be dependent not only upon profits but also upon the cash resources. It has to be borne in mind that payment of dividends deplets the work ing capital. Under these circumstances the prudent course would be, to with-hold the dividend until the cash in excess of the normal requirements is accumulated in the normal course of the business. The basis for a declaration of a dividend should be, not merely a book profit, but in addition a sufficient cash balance.

In case a company has to pass a dividend, and is not in a position to spare cash for the payment of the dividend, the following alternative methods may be suggested :—

(i) The company may have a temporary loan from the bank. This will suit those companies which operate with small working capital or have seasonal trade, or have large book-debts. They can repay without any financial embarrasment on the

realisation of their book-debts or the sale of their stocks.

(ii) Some companies may issue further capital for the payment of the dividends but it can not be considered a sound financial policy. Even the most prosperous concerns may find it difficult to maintain the rate of future dividends when the capital is increased.

(iii) Some companies my issue redeemable preference shares, or debentures repayable after few years. This should be resorted to by those companies who hove used profits for financing block capital expenditure and it would be desirable for them to raise funds of a more permanent nature. The preference shares or debentures should be paid by means of a Sinking Fund created out of profits.

(iv) In cases where a comany does not wish to borrow from the banks or issue furthur share capital or debentures but expects cash in the near future, it may declare Scrip Dividend, which is set aside by issuing to the shareholders the company's 'Promise to pay'. It may or may not bear interest. It is payable at some definite date or earlier at the option of the company. It is usually issued by a company which has made a good profit but is not in a strong position to part with cash and does not wish to borrow, but wants to maintain its dividend record e. g., Tata Iron Steel & Co. Ltd., issued Scrip Dividend in 1942.

(v) Lastly, where a company has satisfactory past profits in the shape of reserves and has earned good current profits it may distribute to the shareholders special dividend out of the accumulated

profits. It cannot possibly pay the huge dividend in cash. Special dividend bonus may be declared and satisfied by the allotment of new shares or debentures of the company or it may be applied in making the shares fully paid up where the issued capital is partly called or paid up. It is known as Capitalisation of profits and the shares or debentures thus issued are known as Bonus Shares or Bonus Debentures.

Conditions in India

The problem of stability of dividends seems to have been neglected in the financial policy of most of the companies in this country while in other countries stable dividend rates are a common feature of the industrial finance. The general tendency seems to be to distribute whatever is available in a particular year without any consideration of the past or of the future. No attempts are made to create reserves or to carry forward balances for the purpose of equalising the dividends when the company has not been able to make good profits. Usually during the boom period high profits are distributed among the share-holders and not retained in the business and the argument is that high rate of dividend is necessary in order to compensate for the low dividends paid during the earlier years. Whatever the reason may be, most companies have not made attempts to create stability of dividends. There is another factor which is responsible for not following such a policy. The shareholders in this country are usually of a speculative type rather than of investors type. They are interested in the fluctuating rate of dividend than in a steady one. Even

the directors and the Managing Agents speculate in the shares.

A few years before the recent war, Indian Finance wrote an article under the heading '*Clive Street Finance, sound but not correct*'. This article described clearly the dividend policy of our companies. It said: "It is a common charge that, in the generality of cases, Bombay Cotton Mills, in extravagant dividend distribution, frittered their profits of prosperous days and that this is the main reason why they were specially unfitted and incapacitated to meat the depression. There is a great deal of force and truth in this charge. The Bombay Mills exploited the present and debilitated the future.

We venture to bring a no less grave charge against the Calcutta companies that, by stingy dividend distribution and by extravagant allocations to depreciation and reserve, they deprive the present shareholders of their just dues. They seek to benefit the future generation of shareholders at the heavy sacrifice of the present. What is needed is a sense of proportion, a balanced plan of action."

That is what was being done before World War II. Soon after the outbreak of the recent war, the Commerce Member to the Government of India made certain statements about the need for conservation of company resources and in his speech on the Finance Bureau in March, 1941, gave a warning to industrialists, when he said.

"Let our industrialists and manufacturers remember that this is a good time for them and

that once peace is declared, there will be such fierce competition from all manufacturing countries which are exactly on the same war production basis as ours which will therefore have to turn round and divert their energies to various manufactured commodities, that at that time our manufacturers and industrialists must have something to fall back upon, namely, the resources that they have built now when they are in a position to make profit, when competition is almost entirely shut out, when at least the internal market is completely at their disposal. I raised that voice of caution last time and I repeat it again with even greater emphasis now, because, as far as I am advised and to the extent that I can personally foresee, the position after the war will be such that all the resources that they have accumulated will be necessary for them. And at that time if any industry, protected or otherwise, has frittered away its resources and is unable to show that it has widely dispensed with all the profits that it has made, no Government will be justified in looking after that industry and giving it a protection which it does not really deserve."

Happily, some of the well-managed companies have taken up the warning thrown out by the Commerce member to heart and have been reserving a part of their profits to strengthen the financial position of their companies, which may deteriorate during the period of depression or for the purposes of rehabilitation in the post-war period. Their policy is usually referred to in the

speeches of the Chairman, of various companies from which the following extracts may be quoted.

"The periods of boom are usually followed by years of depression, and it behoves us to see that we do not dissipate all our earnings of prosperous years without making some provision for the years when profits dwindle down to almost vanishing point and mills find it hard to provide the finance to renew machinary, to expend plant, to meet all other expenditure necessary to meet fierce competition in the falling markets." *The Swedeshi Mills Co., Ltd, Bombay 1943.*

In disposing of the profits made by the company, your directors have been guided by two main considerations, first, the imperative need for conserving the company's resources and strengthening its finances so as to enable us to face the future with confidence. We would have to be prepared for a possible post - war trade slump. At the same time, the need for revitilising and remodernising the mills plant and machinery is very urgent. All this needs plenty of finance and the reserves of nearly Rs. 19 lakhs which we have now built up, should stand us in good stead in meeting this demand. Secondly, your directors have attempted to the best of their ability to cooperate with the Government in their anti-inflanatory measures by resisting the temptation of high dividends out of what may be called War-time prosperity and by retaining the bulk of our earnings in and for the benifit for the industry itself. Thus out of the total profit of Rs. 67 lakhs made

during the past 3½ years, as much as Rs. 42 lakhs have been retained in the industry itself. This has enabled the company not only to become free from all external indebtedness but has also added substantially to its fluid resources."

Shri Krishna Rajendra Mills Ltd, Mysore 1944.

LECTURE VIII

Creation of Reserves.

The fundamental principle is, the earnings cannot be considered as net earnings, i. e., as real earnings, until there is an assurance that the economic value of the physical property of the business has not declined during the period in which these earnings are being made as shown by the business power to earn. Some reserves must be set aside for the simple reason that the life or usefulness of physical property neither corresponds with nor is commensurate with the life of the corporation. There is, therefore, an imperative necessity of having at all times an accurate method of determining its present valuation after the actual expenditure for maintenance has been fully provided. The interest of a company demands that its capital is kept intact and its resources are consolidated and strengthened. Before settling the amounts of profits available for distribution amongst the share-holders, it is essential that adequate provision should be made for the depreciation of assets and taxation liability of a certain portion of the surplus should also be retained in the business for future use. This is done by creating Reserves, which represent profits earned and retained in the business. They are set aside to meet certain contingencies in the future and are, therefore, known as Reserves. A Reserve is created either by charging a certain amount to the Profit and Loss Account or transferring some other surplus.

Reserves may be classified broadly as:—

(i) General Reserves or (ii) Special Reserves.

The former are those which are created out of the profits or other surpluses for the purpose of strengthening the financial position of the company or for making provision for unknown contingencies. It is also known as Reserve Fund.

Special Reserve is set up for some particular purpose such as, a known liability or contingency. It may be designated by the purposes for which it is built up or may be simply called 'Special Reserve'. One meets with instances of special reserves in the Final Accounts of the companies and to illustrate a few may be mentioned:

Dividend Equalisation Reserve, Debenture Redemption Fund, Earthquake Insurance Reserve, Charity Reserve, Fire and Accident Insurance Fund, Workmen's Insurance Fund, Block Improvement Reserve, Employees Benefit Reserve, Labour Bonus Reserve, Labour Welfare Reserve, Reserve for Housing Scheme, Reserve for Bad Debts, Taxation Reserve, Obsolescence Reserve, Machinary Improvement Reserve, Repairs and Renewals Reserve, Depreciation Reserve, Investment Depreciation Fund, Stock Adjustment Account, Rehabilitation Reserve, E. P. T. Deposit Reserve, Special Depreciation Reserve, War Contingency Reserve, Reserve for Fall in Prices, Reserve for Enemy Debts, Reserve for Damage to Factory, and War Risks Factories Contingency Fund.

Creation of Reserves is an important feature of the Company Finance. From the profits earned the essential provision for depreciation and taxation must first be made and then as much as possible should be allocated to reserves for strengthen-

ing and consolidating the financial position of the company. *Mead* in Corporation Finance offers a sound advice, "The policy of sacrificing its dividends to its reserves is the one which every company whose financial position permits, should follow. In no other way can a company, whose permanent earning power, is doubtful, so certainly raise its securities to an investment position as by adherence to the policy of accumulating large reserves out of profits. In no other way can a company whose capitalisation is excessive campared with its earnings justify that capitalisation save by ploughing in its profits making the crop earnings grow up into large harvests of revenue."

It is essential to have depreciation and obsolescence reserves. Similarly other reserves may be necessary in some cases, but depreciation and obsolescence reserves are necessary in all cases. When physical property is employed in the conduct of business, in order that no mistake may be made in the payment of dividends by using a surplus inflated by over-valued assests or under-valued liabilities, the directors must examine the campany's assets and liabilities as given in the detailed Balance-sheets. All the fixed assets should be treated for depreciation purposes. The question of depreciation reserve has to be considered as the first step in the formation of a correct dividend policy. Depreciation has been defined, 'as the shrinkage in value caused by the wearing out of an assest due to its use in the business and the provision for it, represents the allowance made for such wear and tear in the Balance-sheet.'

Before determining the earning capacity of a business, one must take into account the provision made in the past and to be made in future. Although one cannot predict the future with accuracy, but one can estimate liberally by his past experience as to what should be sufficient to keep the book value of fixed assets well within the limits of actual value. If this is not done the figure of profits is over-stated. *Whithers* says in Stocks & Shares, 'the fixed assets gradually lose their value, more or less, according to the manner in which they are used; and for this reason, no company can be said to have made a fair profit until, in addition to the expenses of its business, there has been charged against the revenue a proper amount for depreciation in respect of its fixed assets.' Depreciation should be regarded as a working Expense. The policy of making a provision for it, if profits permit, cannot be regarded as sound. It should not be regarded as a transfer from profits and it should not be shown in arrears to be made good from future profits. In this country, the provision for depreciation has been neglected. In many concerns, depreciation is provided according to the annual net profits. It is quite an unsound policy. In fact it should be charged to revenue so as to include it in the cost of production, so that the proper cost of production may be the basis for the price. It should not be made dependent on the earnings of the business. If it is done so, it becomes easy for the management to misrepresent profit by manipulating depreciation charges according to its needs. The danger is still greater in this country

owing to the Managing Agents system. The remuneration of management depends upon the amount of the profits and naturally they are interested in showing the income as high as possible. There is no clear statutory requirement for its provision unless the Memorandum or Articles specifically provide for it. Specific reference is, however, contained in the provision prescribing the basis for finding net profits on which the remuneration is to be paid to the Managing Agents. The net profits are defined as 'Profits calculated after allowing the usual working charges and depreciation.' The basis for determining the amount of depreciation is, however, not provided and the discretion rests with the directors as to what amount should be provided for. Again, according to Income Tax Act certain allowances for depreciation are allowed but the companies do not actually set aside the same amount for depreciation. Unfortunately most of the industries have not a sound financial policy for depreciation and it is important to give greater attention to this most important aspect of industrial finance.

Assessment Of Depreciation.

The method of assessing the amount of depreciation depends to a very large extent upon the financial policy of the management. Some companies follow a very cautious policy and provide over-depreciation i. e., more than the necessary amount of depreciation. This has been done by Calcutta companies and the book value of their assets appears in their Final Accounts at very low figure. It does not mean that the policy pursued is correct although it is too sound for necessary requirement

of the company. They accumulate their liquid resources far in excess of any contingency. Where this is the case it is desirable to stop the further depreciation so that the assets may be made to appear at their true value. Besides, such a policy deprives the ordinary share-holders of their due share in the profits of the Company. The sound policy in this connection as recommended by *Lough* in business finance is, "The losses due to depreciation should constiute a regular charge against gross income. The amount of that charge should be estimated as accurately as possible and should be adhered to year after year, otherwise, we get a purely fictitious showing of net profits. If large sums were charged off in one year and nothing is charged off next year, the final showing of profits in the two years may be about uniform, whereas the business has perhaps really suffered an enormous fluctuation."

On the other hand, to adhere to a rigid policy of making actual provision for depreciation is not free from danger, in view of the fact that the life of the assets may not have been accurately calculated or estimated. Further, in over-capitalised concerns, the depreciation provision made at normal or statutory rates may present an inaccurate position of the profits-making capacity of the concern.

Adequacy of Depreciation.

Gupta in his Published Accounts says, that the following factors should be considered in making provision for depreciation and in judging its accuracy:-

(i) In cases where depreciation is provided for only when there are profits, the size of profits should

be taken into account. It must be realised, however, that the depreciation does not depend upon the amount of profits. According to *Lough*, "It is an actual element in the operation of every business; it is going on day and night; through all seasons; year after year; in periods of depression as well as in periods of prosperity."

(ii) Sometimes a company feels a necessity of allowing some dividend even if full provision for depreciation cannot be made. The reason may be to maintain the market value of the company's shares.

(iii) The amount to be provided must depend upon the condition of the assets. e. g., if the assets are new, or the assets are kept in proper repair, the need for depreciation is less.

(iv) In cases where excessive depreciation has been provided in the past and the assets have been sufficiently written down, the need for its furture provision is less.

(v) If during the past years, enough provision has not been made which may be due to causes like depression, it may be necessary to make provision for large amounts to provide for past arrears,

(vi) If a company has made sufficient reserves apart from depreciation to support the block account it can afford to reduce the provision for depreciation if it is necessary to do so on account of certain reasons e. g., reduced earnings.

(vii) If on the reconstruction of the capital structure or on the revaluation of its assets, ample amounts have been written off the block account,

the need for further depreciation is reduced to the same extent; for instance, if the capital is reduced, the depreciation should be provided on a lower basis.

(viii) Lastly, during the war period, the companies had to make greater provision for depreciation which was rendered necessary by the conditions under which they worked. Some companies enjoyed war-time prosperity and could afford to make a greater provision in order to consolidate their position with a view to meet the post-war difficulties when competition will have to be faced. During the war period, plant and machinery were subjected to the maximum strain and consequently there was a greater wear and tear. Some companies had to purchase special plants which may have to be scrapped after the war. It had to be written out of war-profits. In some cases, capital assets had to be acquired at inflated prices and must, therefore, be adequately depreciated. In such cases the replacement cost would be higer in future years than in the normal times and should be provided for during the period of boom by larger provision of depreciation.

Creation of other Reserves:

Another group of assets which the directors must examine carefully, is that known as Receivables i. e., accounts owing to the company Bills Receivable etc. They represent generally money due to the corporation for goods and services sold and delivered. Some of them may be irrecoverable, and it is customary to reduce the amount by reserves for bad and doubtful debts equal to the

estimated amount of the debts that will not be collected.

Then it is necessary to scrutinise the assets known as working assets. If a company has a large amount of raw materials, materials in process of manufacture and finished products, it may have included among its assets a quality of unsaleable goods which either might have been written down or offset by a reserve. This is very important in times of falling prices, as the prices of goods may fall rapidly and the values placed in the Balance Sheet to represent them may be too high. The assets such as patents, copy rights, should not be carried as large balances. The conservative practice is to give them a reasonable value at the inception and to write off over their period of usefulness.

Sometimes the Directors desire to undertake the expansion of the business that will use the earnings of the company for a number of years. The share-holders may be told that they need not expect dividends out of their appropriated earnings. This is known as ploughing in the earnings with the property. This appropriation will be used for working capital or the Reserves may be used for the construction and expansion of the fixed assets.

In the days of high taxes, a reserve for taxes is necessary or a specific fund has to be set aside to redeem an obligation at maturity e. g., debenture redemption fund, or a reserve may be created to meet a contingent liability. For instance, it was considered necessary to make a separate provision for taxation before declaring a dividend as the

Income-tax, Corporation Tax and E. P. T., assumed special importance and its incidence steadily increased. "Sound finance requires that before fixing the amount of dividend payable to shareholders, a company's taxation liability in respect of income-tax, corporation-tax and E. P. T., based on the years' profits should be carefully estimated and an adequate reserve set up therefrom. This is the method followed by all well-managed concerns in India. Almost all companies, liable to taxation, set up special reserve for it ; but there are still a few companies, which do not do so on the ground that they cannot estimate their taxation liability. Such companies, however, carry forward a sufficiently large amount of profit with a view to meet the taxation liability when it is actually settled by Authorities." *Gupta Published Accounts.*

Some companies use the services of Insurance companies in distributing risks but others create their own assurance funds and in such cases the companies instead of paying premiums to insurance companies, usually set up an Insurance Reserve and invest the amounts that would be turned over to the Insurance companies in the extention and improvement of its properties. In such a case the directors must be careful to guard against loss of property that must be replaced immediately.

Frequently, corporations promise their employees various forms of pensions. The funds which will be needed to meet these obligations should be accumulated from year to year by reducing its surplus profits by a sum estimated to be necessary for the purpose. Such a reserve may be called a

reserve for pensions. Similarly, a company may be engaged in welfare work and may build houses and rest rooms for the employees. Such capital assets coming from profits can hardly be called the producing assets, and will, therefore, be offset by a reserve.

A Dividend Equalisatian Reserve Fund may also be created, the purpose of which is to keep in the company a sufficient amount of profits to equalise dividends for the lean years.

Reserves are earmarked portions of the surplus. If a company accumulates a reserve much larger than the requirement for which it is established it may use the amount for paying dividends. Before doing so it is necessary to draw the attention of the share-holders to the change that has been made.

A secret Reserve is one that is built up through charging capital expenditure to the revenue account. In this manner the assets may not be revealed as assets. It may be that the assets have been increased although the balance-sheet does not show any increase and there exists a secret reserve.

Sinking Funds.

A Sinking Fund reserve created out of profits is usually invested outside the business in securities which can be cashed. The object of a Sinking Fund is to provide a definite sum at a definite date in future which may be required for repaying a liability or replacing a wasting asset. It grows each year with the aid of yearly contribution and interest. It is built up by setting aside a certain amount out of profits and by investing

it at compound interest outside the business in order to produce the required sum at the end of a given period. When the money is required for repaying the liability or replacing the asset, the investments are sold and out of the sale proceeds, the liability is repaid or the new asset is purchased. If a Sinking Fund is held for the purchase of a new asset, it will be used to wipe off the old asset, when a new asset has been acquired out of the sale proceeds of the investments. It must be clearly understood that when a Sinking Fund is desired to be set up, the following assumptions are made :—

(i) That the profits of the company each year will be sufficient to permit the annual contribution to be made.

(ii) That there will be sufficient cash available each year to make the contribution to be invested outside the business and

(iii) That it will be possible to invest the amount every year at the same rate of interest.

With regard to the investment of the Sinking Fund, it is not necessary that the contributions must be invested outside. The Copany may have the option of utilising it in its own business. In case a company already holds large investments, there is no necessity of making fresh investments on account of the Sinking Fund. Some of the existing investments may be earmarked for that purpose. Where it is done so, the fact must be disclosed. in the Balance-sheet.

Capital Reserves.

A Capital Reserve is one which is not available for distribution as dividend. It is usually derived from the following sources :—

(a) Capital profits — such profits sa earned prior to incorporation, profits made on the purchase of the business, premium received on the issue of shares and debentures, profit on the sale of forfeited shares.

(b) Any balance remaining in the capital reduction Account where the share-capital of the company is reduced.

(c) Any General Reserve standing in the books of the company whose share capital has been reduced, and

(d) Profits of an exceptional nature.

In the provision of reserves, there is a difference in practice in America and Europe. After all, various reserves are fictitious entries on the Liability side meant to reduce the surplus. In America the practice has been to let one General Account stand for all these reserves and call it Surplus. In other words, American corporations always maintain a large surplus, the purpose of which is to accomlish the many objects for which companies in other countries set up separate reserves. The advantages of keeping such a surplus are :—

(i) It strengthens comany's credit and enables the company to make its interest and dividend payments uniform and dependable.

(ii) It enables the company on the strength of this credit, to obtain capital requirements on the most favourable terms.

(iii) It enables the company to pass through commercial and financial disturbances.

(iv) It enables the company to meet at all times the highest stages of efficiency, and

(v) It enables the company to maintain even and uniform disbursements from reserves and maintain a uniform operation of organisation in a high scale of efficiency.

LECTURE IX

Integration Of Business

The integration is a modern type of consolidation. It is an enterprise in which it is possible to reach back to the primary raw material and forward to the ultimate consumer. A business concern originally controlling only an intermediate process of manufacture acquires by consolidation other concern which produces its cheif raw material and still another which distributes to retailers or even to consumers its finished product. In this way, it controls the entire course from the raw material to the selling of the product, for instance a shoe factory may require tanneries and shoe stores. These combinations are certainly not always successful because the close integration removes the spur of buying and selling at the different stages of manufacture and distribution at comparative rates. But many of them have succeeded on account of the economies which such a combination can effect. Integration has been one of the chief reasons for the success of many important American concerns.

Consolidation may be either Partial or Complete. In the former case, the individual units remain separate but the interest of the controlling number of shareholders of each business is combined and so merged together that the direction and management of all separate organisations is in the hands of one Central Body, e. g., a Holding Company. In the latter case, the combining units amalgamate and are fused into one in the interest of all. It may be effected by means of

Amalgamation, Absorption, or Merger of companies. If a new company is formed to acquire the existing companies it is known as Amalgamation; but if one existing company swallows up a number of existing companies, it is called an Absorption. In America, amalgamation and absorption are respectively termed as Consolidation and Merger. When the combination takes place, one huge organisation comes into being in the place of several business units which lose their separate entities. They differ in their methods and in the technical process of approach but the purpose and effect of both are the same. They combine the interests of competing companies and their shareholders in such a way that they are all fused together into one complete whole.

Holding Company.

A Holding Company is a form of business organisation which is created for the purpose of combining other companies by owning a controlling amount of their stock. It purchases either on the open market or by a private agreement a large amount of securities with a view to control the direction and management of other companies. When a company purchases the shares of other competing companies, it is called a Mixed or Operating Holding Company. It holds not only the stocks of the constituent companies but also operates their plants. On the other hand, a pure Holding company merely holds the stocks of operating companies without engaging directly in any of the technical processes of production. Holding companies may again be divided as Primary and Intermediary

companies. A Primary holding company is one which constitutes iteslf as the sole head of the organisation while an Intermediary holding company is a subsidiary company under the control of a Primary company. The object of the latter is to facilitate control by a single company over other companies or to enable one group of companies to establish a joint control over one or more companies.

Holding companies may again be divided according to the object with which they are formed as for instance, the Finance and Investment Holding companies, and Manufacturing and Transport, Holding companies.

Investment Companies.

Finance & Investment Holding companies have for their object the promotion of financial operations and investments without combining competing organisations. Such companies purchase shares of different companies, not with a view to control those companies but to obtain the maximum advantage for its shareholders with the minimum of risk. Such an institution is very useful to the investors of moderate means who usually do not have the requisite knowledge to select their securities properly and cannot differentiate the good securities from the bad.

Such investors should not invest a large amount of money in the shares of one company only or in several companies in the same industry, or in different industries in the same area. This is the reason why the shares should be

purchased on the principle of 'Diversification of investments.' An investor is not in a position to make a proper selection of securities, nor can he get the benefits of diversification of investments by direct and independent investments. This difficulty is overcome by an indirect investment through an Investment Company. Such a company engages the services of experts who understand the prospects of different companies and the intricacies of the money market to select suitable securities which will earn the maximum amount of profits for its shareholders. Again, in the case of direct investment, an investor is likely to lose a large amount of capital if some of the companies fail. If the investment is indirect and one purchases the shares of an Investment company, the probability of such a loss is little. Under the guidance of experts, the company whose securities are purchased, will not ordinarily fail but, if any company fails the loss to the investment company itself will not be heavy because its investments in the securities of any one company, are proportionately very little. Consequently the loss to the individual shareholder will be negligible. Even if there is any, it may be compensated by appreciation in the values of other securities purchased through sound investments. Again, from the point of view of income, there is an advantage to the investor in such an investment. In the case of direct investment, if a company does not pay any dividend, he may receive no income. But in the case of indirect investment, some companies may earn more and others less but the total income of the invest-

ments company will not differ very much from year to year and the income of its shareholders will be more or less constant. Investment companies are, therefore, of great advantage to investors. They are a great check on the reckless promoters and encourage investments and the promotion of companies in the proper direction.

Finance Holding Companies : These are the companies, the primary function of which is to make profits by financing the operations of other companies through promotions, under-writing or re-organisation. It may incidently exercise control over the companies financed by it. As their name implies, financing is their main purpose and their income is derived from the interest received from financing.

Difference between a Holding Company and a Complete Consolidation.

The Holding company retains the separate existence of the combined organisations and controls them by the power of voting which it possesses by having a majority of the shares which carry with them votes. It cannot act directly for the companies controlled by it and has to act through the directors of the respective companies. It is, therefore, a temporary consolidation. The constituent members must be Joint stock companies. In a complete Consolidation, the combining units are no longer separate and independent—they fuse together and become one, and consequently the question of controlling does not arise. It is not necessary that the combining members must be joint-stock companies. It is an operating unit and manages all the

concerns directly. Again, in a Holding Company, only a few shareholders of the constituent Companies combine and this may result in conflicting interests between the share-holders who have formed the Holding Company and those who are not in the combination. This is not so in the complete consolidation, where the interests of all the share-holders of all the combining companies are fused together and are alike.

Advantages of Combinations:

The advantages of combinations may be stated as follows:—

(i) It is possible to obtain economies of large-scale production and organisation. Purchasing of raw materials and stores and machinery can be effected economically as they are made in bulk; better selection and lower transportation charges can be arranged; control over the sources of raw material is acquired; middlemen are eliminated; products are manufactured on large-scale. Mass production becomes possible by standardisation, specialisation and simplification. In the matter of sales competition and over-production are avoided. Factories which cannot be run economically, may either be closed or improved

(ii) *Economy in Finance:*—The working capital of a combination is normally very large. Finance can be raised on better terms. In case there is a surplus of funds, it can be invested advantageously temporarily.

(iii) *Economy in administration:*—The administration and control of a combination is centralised. It makes possible the appointment of experts and

specialists. The services of most competent available for the benefit of all the concerns combined.

(iv) *Maintenance of selling prices:* The elimination of competition renders price-cutting policies unnecessary. Selling prices are controlled and fair prices are charged for all products, better conditions of sales may also be secured.

(v) *Sound Investment:*—A combination offers sound investment to the investors. The securities of the consolidated companies are steady. In the case of consolidation, the value of the securities fluctuates very little. The investor who wants a steady income will invest in the securities of the consolidated companies.

Evils of Combinations.

(a) Cansolidation may lead to monopoly. This can be avoided by encouraging combinations in such a way that there may be a few consolidated companies to maintain competition.

(b) *Inefficient management:*—a large consolidation may become too big to be controlled by one or few individuals.

(c) *Lack of Initiative:* The heads of the combinations may lose interest and may show a lack of initiative on account of the fact that the best effort put in the management will not bring them any reward but will go to the credit of combination.

(d) *Over-capitulisation:* Combinations are generally over-capitalised, and suffer from the evils of the over-capitalisation. There may be a spirit of speculation in the directors. The capital may be watered. Consequently the investors and share-

holders may lose.

(e) *Unemployment*: Consolidation is opposed by workmen as it is regarded prejudicial to their interests by causing unemployment as a result of checking over-production which is the primary object of a consolidation.

Slow growth of combinations in India :

The combination movement in Indian industries has been rather slow as compared with other industrially advanced countries. The reasons are not far to seek. The country is still industrially backward and no necessity has been felt by industrialists to combine. The industrial magnates wish to keep up their independence in the management of the concerns controlled and managed by them. The reason which is responsible to a large extent for the absence of industrial combinations in this country is the Managing Agency System, which provided the economies of combinations by group management of industrial concerns. It has a great influence on the structure of industrial organisation, while there have been developments abroad resulting in the formation of cartels, syndicates, combines, trusts, holding companies etc. Indian industry has offered a form of organisation unique in some respects. They manage and control undertakings in the same industry and also a number of enterpises in different industries. So they might be said working partly on the lines of horizontal combination and partly as vertical combination. But clearly it is neither a case of horizontal combination nor a vertical combination. In combinations the companies have to lose their

independence and in some ways even their existence. In the case of companies managed by Managing Agents each company has a separate existence although there is a coordination of control by the central office. This coordination and control works to the advantage of different concerns. Thus in Indian industries there is integration in administrative and financial aspects in the form of managing agents.

In addition, there have been certain amalgamations and mergers with the object of eliminating competition or having a big business by combining together several units. For example, the British India Corporation Ltd., has taken over several companies engaged in various industries. They have become the property of the corporation and some are known as branches of the corporation as they have been dissolved while others are still subsidiary companies. Similarly, the Associated Cement companies Ltd., is a big merger to amalgamate a large number of cement companies. The Cement Marketing Company of India Ltd., and the Indian Jute Mills Association are Cartels. The former has done much to increase sales and at the same time reduce the cost of cement to the consumer. The Indian Jute Mills Association controls the industry in its productive capacity, finances and encourages technical developments in plant and machinery, helps in the opening out of new markets etc. It has served well the industry and the users of its products. Again, Indian Sugar Syndicate is a combination of the U. P. and Behar sugar manufacturers. It controls the sale of sugar by fixing

quotas and minimum selling prices.

In the matter of combines in industry much has still to be attempted and achieved. During the post-war period some sort of integration and combination of Indian industry is essential. If the industry and commerce of the country are to survive the integration should be immediately brought about in the key and major industries in the interest of the country.

Reorganisation of Companies.

By reorganisation of companies we mean the reconstruction of the companies. It refers to the sale of the business of an existing company to another company which may be already in existence or may be incorporated for the purpose. Such a reconstruction is resorted to under two cases. In the first place when a company has lost its capital and wishes to write it off or when the company wishes to raise additional capital by exchanging fully paid up shares for partly paid up shares. In the second case when it is proposed to amalgamate the existing companies, or a company wishes to absorb some other companies, reconstruction may be brought about in the following ways:—

(i) If the Memorandum of Association of a Company confers the necessary power, the directors may sell the company's business with the consent of the company in General Meeting. If it is intended to distribute the sale proceeds amongst the shareholders and wind up the company, the reconstruction must be done under Section 208 C. Under this Section a sale of a company's business becomes

necessary when it needs more capital and cannot get it easily from the existing shareholders. The company has to go into voluntary liquidation and a new company is formed with practically the same name. The liquidator of the old company sells its business to the new company in such a way that each shareholder in the old company is entitled to one or more shares in the new company. The shares in the new company may be partly paid and each shareholder must undertake a fresh liability for calls. Under this section the sale of the business may also be made to another existing company and the consideration may be satisfied by the issue of fully paid up shares. This happens where the company is reconstructed for the purposes ef amalgamation.

A reconstruction or amalgamation can also be carried out as a scheme of arrangement under section 153. When this is done the court may make an order vesting the property of the old company in the purchasing company and providing for the distribution to the old company's members of shares in the purchasing company.

Amalgamation of companies.

Amalgamation may take place in two ways. Firstly by the formation of a new company to take over the business of two or more existing companies and, secondly, by the absorption of the business of one company by another company. As already explained above under Section 153 and 208C the business of one company may be transferred to another company, the vendor company may be wound up voluntarily or may be dissolved by the court and then disappear altogether

Section 153 B makes provisions for the amalgamation of companies under a scheme which does not require the passing of any resolutions at meetings. If a company after consultation with the directors of another company makes an offer to the shareholders of a company to buy their shares either for cash or for shares and if within four months the holders of nine-tenths of the shares of the company accept the offer then the company which makes the offer may at any time within two months after the expiration of the prescribed four months give notice to any dissenting shareholders that it desires to acquire their shares on the same terms as the original offer. The company then becomes entitled to acquire the shares. The purchasing company hands over the consideration to the other company which has to register the purchasing company as the holder of the shares. This procedure is known as an amalgamation by the formation of a holding company. In case a new company is to be formed for amalgamation, the liquidator of the purchased company will distribute the share of the new company in a manner similar to that adopted in the case of reconstruction of a company. Where one acquires the business of another company and the latter company goes into liquidation, there is an amalgamation by absorption. Usually the absorbing company takes over all the assets and liabilities of the absorbed company. When absorption takes place the absorbing company either has or creates by increasing its capital sufficient unissued shares to be alloted in satisfaction of the agreed purchase price of the

undertaking absorbed. The purchase price is usually fixed after a careful valuation of the vendor company's assets and liabilities but in some cases the purchase price is settled on the basis of the market value of the vendor company's shares. It may result either in profit or loss to the company absorbed.

QUESTIONS

1. Under what cicumstances is the issue of fresh capital by the existing industrial concerns justified ? What would be the effect of such issue on future dividends?

2. Why should depreciation be set aside in the Balance Sheet of an industrial concern . Describe the manner in which this is done. What use is generally made by companies of such funds?.

3. Examine the part played by different types of financial institutions in meeting the financial needs of industries. Illustrate your answer from Indian conditions.

4. What services are rendered by underwriters in the promotion of companies ? Are these services of great importance to the development of industries?

5. Industrial Banks have not developed in India to the extent they should have. What are the reasons for this state of things? What part is played by Industrial Banks in the promotion and financing of industries?

6. It is said that industrial concerns suffer in some cases from under-capitalisation. Discuss the evils of under capitalisation and over-capitalisation.

7. What are the different ways in which a company can secure the working finance for carrying out its work. Which of them are to be preferred and why?

8. Under what circumstances is an industrial corporation justified in resorting to long term borrowing ?

9. Examine the relation between banks and joint stock business in India and show in what direction they need improvement.
10. Discuss the distinctive features of the various classes of shares and show how they suit different types of investors.
11. Examine the part played by the Stock Exchange in India as an investment market.
12. Show how profits made by joint stock concern are appropriated with special reference to the essentials of a sound dividend policy.
13. Discuss the significance of reserves in the Balance Sheet of a Company. How is the financial and general working of a company affected by reserves for different purposes or their absence ?
14. Outline the organisation and functions of different types of investment trusts and account for the slow progress made by them in this country.
15. Compare the methods of obtaining working capital in India with those found in the United Kingdom and U. S. A.
16. What is an industrial merger and why are such mergers rare in this country ? Explain the financial problems that have to be solved on its formation.
17. What is meant by the term financial reorganisation of a company ? In what circumstances does it become necessary. Discuss the legal requirements for such a reorganisation.
18. What are company promoters ? What functions do they perform in connection with the flotation of companies ? Discuss any peculiarities of Company promotion in this country.
19. Discuss the importance of deposits from the public in financing the Cotton mill industry in the Bombay Presidency. Point out any demerits of the system. Should it be continued ?.
20. What suggestions would you make to meet the financial needs of the industrial concerns in the post-war industrial reconstruction in this country ?